(b) **Holding period for distributed property.** A partner’s holding period for property distributed to him by a partnership shall include the period such property was held by the partnership. The provisions of this paragraph do not apply for the purpose of determining the 5-year period described in section 735(a)(2) and paragraph (a)(2) of this section. If the property has been contributed to the partnership by a partner, then the period that the property was held by such partner shall also be included. See section 1223(2). For a partnership’s holding period for contributed property, see §1.723-1.

(c) **Effective date.** Section 735(a) applies to any property distributed by a partnership to a partner after March 9, 1954. See section 771(b)(2) and paragraph (b)(2) of §1.771-1. However, see section 771(c).

§1.736-1 **Payments to a retiring partner or a deceased partner’s successor in interest.**

(a) **Payments considered as distributive share or guaranteed payment.** (1)(i) Section 736 and this section apply only to payments made to a retiring partner or to a deceased partner’s successor in interest in liquidation of such partner’s entire interest in the partnership. See section 761(d). Section 736 and this section do not apply if the estate or other successor in interest of a deceased partner continues as a partner in its own right under local law. Section 736 and this section apply only to payments made by the partnership and not to transactions between the partners. Thus, a sale by partner A to partner B of his entire one-fourth interest in partnership ABCD would not come within the scope of section 736.

(ii) A partner retires when he ceases to be a partner under local law. However, for the purposes of subchapter K, chapter 1 of the Code, a retired partner or a deceased partner’s successor will be treated as a partner until his interest in the partnership has been completely liquidated.

(2) When payments (including assumption of liabilities treated as a distribution of money under section 752) are made to a withdrawing partner, that is, a retiring partner or the estate or other successor in interest of a deceased partner, the amounts paid may represent several items. In part, they may represent the fair market value at the time of his death or retirement of the withdrawing partner’s interest in all the assets of the partnership (including inventory) unreduced by partnership liabilities. Also, part of such payments may be attributable to his interest in unrealized receivables and part to an arrangement among the partners in the nature of mutual insurance. When a partnership makes such payments, whether or not related to partnership income, to retire the withdrawing partner’s entire interest in the partnership, the payments must be allocated between (i) payments for the value of his interest in assets, except unrealized receivables and, under some circumstances, good will (section 736(a)), and (ii) other payments (section 736(b)). The amounts paid for his interest in assets are treated in the same manner as a distribution in complete liquidation under sections 731, 732, and, where applicable, 751. See paragraph (b)(4)(ii) of §1.751-1. The remaining partners are allowed no deduction for these payments since they represent either a distribution or a purchase of the withdrawing partner’s capital interest by the partnership (composed of the remaining partners).

(3) Under section 736(a), the portion of the payments made to a withdrawing partner for his share of unrealized receivables, good will (in the absence of an agreement to the contrary), or otherwise not in exchange for his interest in assets under the rules contained in paragraph (b) of this section will be considered either:

(i) A distributive share of partnership income, if the amount of payment is determined with regard to income of the partnership; or

(ii) A guaranteed payment under section 707(c), if the amount of the payment is determined without regard to income of the partnership.
§ 1.736–1 Payments, to the extent consid-
ered as a distributive share of partner-
ship income under section 736(a)(1), are
taken into account under section 702 in
the income of the withdrawing partner
and thus reduce the amount of the dis-
tributive shares of the remaining part-
tners. Payments, to the extent consid-
ered as guaranteed payments under
section 736(a)(2), are deductible by the
partnership under section 162(a) and
are taxable as ordinary income to the
recipient under section 61(a). See sec-
tion 707(c).

(5) The amount of any payments
under section 736(a) shall be included in
the income of the recipient for his tax-
able year with or within which ends
the partnership taxable year for which
the payment is a distributive share, or
in which the partnership is entitled to
deduct such amount as a guaranteed
payment. On the other hand, payments
under section 736(b) shall be taken into
account by the recipient for his taxable
year in which such payments are made.
See paragraph (b)(4) of this section.

(6) A retiring partner or a deceased
partner’s successor in interest receiv-
ing payments under section 736 is re-
garded as a partner until the entire in-
terest of the retiring or deceased part-
ner is liquidated. Therefore, if one of
the members of a 2-man partnership re-
tires under a plan whereby he is to re-
cieve payments under section 736, the
partnership will not be considered ter-
minated, nor will the partnership year
close with respect to either partner,
until the retiring partner’s entire in-
terest is liquidated, since the retiring
partner continues to hold a partnership
interest in the partnership until that
time. Similarly, if a partner in a 2-man
partnership dies, and his estate or
other successor in interest receives
payments under section 736, the part-
nership shall not be considered to have
terminated upon the death of the part-
ner but shall terminate as to both part-
ners only when the entire interest of
the decedent is liquidated. See section
708(b).

(b) Payments for interest in part-
nership. (1) Payments made in liquidation
of the entire interest of a retiring part-
nor or deceased partner shall, to the
extent made in exchange for such part-
nor’s interest in partnership property
(except for unrealized receivables and
good will as provided in subparagraphs
(2) and (3) of this paragraph), be consid-
ered as a distribution by the partner-
ship (and not as a distributive share or
guaranteed payment under section
736(a)). Generally, the valuation placed
by the partners upon a partner’s inter-
est in partnership property in an arm’s
length agreement will be regarded as
correct. If such valuation reflects only
the partner’s net interest in the prop-
erty (i.e., total assets less liabilities),
it must be adjusted so that both the
value of the partner’s interest in prop-
erty and the basis for his interest take
into account the partner’s share of
partnership liabilities. Gain or loss
with respect to distributions under sec-
tion 736(b) and this paragraph will be
recognized to the distributee to the ex-
tent provided in section 731 and, where
applicable, section 751.

(2) Payments made to a retiring part-
nor or to the successor in interest of a
deceased partner for his interest in un-
realized receivables of the partnership
in excess of their partnership basis, in-
cluding any special basis adjustment
for them to which such partner is enti-
tied, shall not be considered as made in
exchange for such partner’s interest in
partnership property. Such payments
shall be treated as payments under sec-
tion 736(a) and paragraph (a) of this
section. For definition of unrealized re-
ceivables, see section 751(c).

(3) For the purposes of section 736(b)
and this paragraph, payments made to
a retiring partner or to a successor in
interest of a deceased partner in ex-
change for the interest of such partner
in partnership property shall not in-
clude any amount paid for the part-
nor’s share of good will of the partner-
ship. Such payments shall be con-
sidered as payments under section
736(b). To the extent that the part-
nership agreement provides for a
reasonable payment with respect to such
good will, such payments shall be treated
under section 736(b) and this paragraph. Gen-
erally, the valuation placed upon good
will by an arm’s length agreement of
the partners, whether specific in
amount or determined by a formula,
shall be regarded as correct.

(4) Payments made to a retiring part-
nor or to a successor in interest of a de-
cased partner for his interest in inven-
tory shall be considered as made in ex-
change for such partner’s interest in
partnership property for the purposes
of section 736(b) and this paragraph.
However, payments for an interest in
substantially appreciated inventory
items, as defined in section 751(d), are
subject to the rules provided in section
751(b) and paragraph (b) of § 1.751–1.
The partnership basis in inventory items as
to a deceased partner’s successor in in-
terest does not change because of the
death of the partner unless the part-
nership has elected the optional basis
adjustment under section 754. But see
paragraph (b)(3)(iii) of §1.751–1.

(5) Where payments made under sec-
tion 736 are received during the taxable
year, the recipient must segregate that
portion of each such payment which is
determined to be in exchange for the
partner’s interest in partnership prop-
erty and treated as a distribution under
section 736(b) from that portion
treated as a distributive share or guar-
anteed payment under section 736(a).
Such allocation shall be made as fol-
lows:

(i) If a fixed amount (whether or not
supplemented by any additional
amounts) is to be received over a fixed
number of years, the portion of each
payment to be treated as a distribution
under section 736(b) for the taxable
year shall bear the same ratio to the
total fixed agreed payments for such
year (as distinguished from the amount
actually received) as the total fixed
agreed payments under section 736(b)
bear to the total fixed agreed payments
under section 736(a) and (b). The bal-
ance, if any, of such amount received
in the same taxable year shall be treat-
ed as a distributive share or a guaran-
teed payment under section 736(a) (1) or
(2). However, if the total amount re-
cieved in any one year is less than the
amount considered as a distribution
under section 736(b) for that year, then
any unapplied portion shall be added to
the portion of the payments for the fol-
lowing year or years which are to be
treated as a distribution under section
736(b). For example, retiring partner W
who is entitled to an annual payment
of $6,000 for 10 years for his interest in
partnership property, receives only
$3,500 in 1955. In 1956, he receives
$10,000. Of this amount, $8,500 ($6,000
plus $2,500 from 1955) is treated as a dis-
tribution under section 736 (b) for 1956;
$1,500, as a payment under section
736(a).

(ii) If the retiring partner or deceased
partner’s successor in interest receives
payments which are not fixed in
amount, such payments shall first be
treated as payments in exchange for
his interest in partnership property
under section 736(b) to the extent of
the value of that interest and, there-
after, as payments under section 736(a).

(iii) In lieu of the rules provided in
subdivisions (i) and (ii) of this subpara-
graph, the allocation of each annual
payment between section 736 (a) and (b)
may be made in any manner to which
all the remaining partners and the
withdrawing partner or his successor in
interest agree, provided that the total
amount allocated to property under
section 736(b) does not exceed the fair
market value of such property at the
date of death or retirement.

(6) Except to the extent section 751(b)
applies, the amount of any gain or loss
with respect to payments under section
736(b) for a retiring or deceased part-
nor’s interest in property for each year
of payment shall be determined under
section 731. However, where the total of
section 736(b) payments is a fixed sum,
a retiring partner or a deceased part-
nor’s successor in interest may elect
(in his tax return for the first taxable
year for which he receives such pay-
ments), to report and to measure the
amount of any gain or loss by the dif-
ference between:

(i) The amount treated as a distribu-
tion under section 736(b) in that year,
and

(ii) The portion of the adjusted basis
of the partner for his partnership inter-
est attributable to such distribution
(i.e., the amount which bears the same
proportion to the partner’s total ad-
justed basis for his partnership interest
as the amount distributed under sec-
tion 736(b) in that year bears to the
total amount to be distributed under section 736(b).

A recipient who elects under this subparagraph shall attach a statement to his tax return for the first taxable year for which he receives such payments, indicating his election and showing the computation of the gain included in gross income.

(7) The provisions of this paragraph may be illustrated by the following examples:

Example 1. Partnership ABC is a personal service partnership and its balance sheet is as follows:

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>Adjusted basis per books</th>
<th>Market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$13,000</td>
<td>$13,000</td>
</tr>
<tr>
<td>Unrealized receivables</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Capital and section 1231 assets</td>
<td>20,000</td>
<td>23,000</td>
</tr>
<tr>
<td>Total</td>
<td>33,000</td>
<td>66,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>LIABILITIES AND CAPITAL</th>
<th>Per books</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liabilities</td>
<td>$3,000</td>
<td>$3,000</td>
</tr>
<tr>
<td>Capital:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>A</td>
<td>10,000</td>
<td>21,000</td>
</tr>
<tr>
<td>B</td>
<td>10,000</td>
<td>21,000</td>
</tr>
<tr>
<td>C</td>
<td>10,000</td>
<td>21,000</td>
</tr>
<tr>
<td>Total</td>
<td>33,000</td>
<td>66,000</td>
</tr>
</tbody>
</table>

Partner A retires from the partnership in accordance with an agreement whereby his share of liabilities ($1,000) is assumed. In addition he is to receive $9,000 in the year of retirement plus $10,000 in each of the two succeeding years. Thus, the total that A receives for his partnership interest is $30,000 ($29,000 in cash and $1,000 in liabilities assumed). Under the agreement terminating A’s interest, the value of A’s interest in section 736(b) partnership property is $12,000 (one-third of the total capital gain of $36,000, the sum of $13,000 cash and $23,000, the fair market value of capital and section 1231 assets). A’s share in unrealized receivables is not included in his interest in partnership property described in section 736(b). Since the basis of A’s interest is $11,000 ($10,000 plus $1,000, his share of partnership liabilities), he will realize a capital gain of $1,000 ($12,000 minus $11,000) from the disposition of his interest in partnership property. The remaining $18,000 ($30,000 minus $12,000) will constitute payments under section 736(a)(2) which are taxable to A as guaranteed payments under section 707(c). The payment for the first year is $10,000, constituting of $9,000 in cash, plus $1,000 in liability assumed (section 752(b)). Thus, unless the partners agree otherwise under subparagraph (5)(iii) of this paragraph, each annual payment of $10,000 will be allocated as follows: $6,000 (18,000/30,000 of $10,000) is a section 736(a)(2) payment and $4,000 (12,000/30,000 of $10,000) is a payment for an interest in section 736(b) partnership property. (The partners may deduct the $6,000 guaranteed payment made to A in each of the 3 years.) The gain on the payments for partnership property will be determined under section 731, as provided in subparagraph (6) of this paragraph. A will treat only $4,000 of each payment as a distribution in a series in liquidation of his entire interest and, under section 731, will have a capital gain of $1,000 when the last payment is made. However, if A so elects, as provided in subparagraph (6) of this paragraph, he may treat such gain as follows: Of each $4,000 payment attributable to A’s interest in partnership property, $333 is capital gain (one-third of the total capital gain of $1,000), and $5,667 is a return of capital.

Example 2. Assume the same facts as in example 1 of this subparagraph except that the agreement between the partners provides for payments to A for 3 years of a percentage of annual income instead of a fixed amount. Unless the partners agree otherwise under subparagraph (5)(iii) of this paragraph, all payments received by A up to $12,000 shall be treated under section 736(b) as payments for A’s interest in partnership property. His gain of $1,000 will be taxed only after he has received his full basis under section 731. Since the payments are not fixed in amount, the election provided in subparagraph (6) of this paragraph is not available. Any payments in excess of $12,000 shall be treated as a distributive share of partnership income to A under section 736(a)(1).

Example 3. Assume the same facts as in example 1 of this subparagraph except that the payment for A’s interest in partnership property shall include payment for his interest in the good will of the partnership. At the time of A’s retirement, the partners determine the value of partnership good will to be $9,000. The value of A’s interest in partnership property described in section 736(b) is thus $15,000 (one-third of $45,000, the sum of $13,000 cash and $23,000, the value of capital and section 1231 assets, plus $9,000 good will). From the disposition of his interest in partnership property, A will realize a capital gain of $4,000 ($15,000 minus $11,000) the basis of his interest. The remaining $15,000 ($30,000 minus $15,000) will constitute payments under section 736(a)(2) which are taxable to A as guaranteed payments under section 707(c).

Example 4. Assume the same facts as in example 1 of this subparagraph except that the capital and section 1231 assets consist of an
§ 1.737–1 Recognition of precontribution gain.

(a) Determination of gain—(1) In general. A partner that receives a distribution of property (other than money) must recognize gain under section 737 and this section in an amount equal to the lesser of the excess distribution (as defined in paragraph (b) of this section) or the partner’s net precontribution gain (as defined in paragraph (c) of this section). Gain recognized under section 737 and this section is in addition to any gain recognized under section 731.

(2) Transactions to which section 737 applies. Section 737 and this section apply only to the extent that a distribution by a partnership is a distribution to a partner other than property previously contributed to the partnership by the distributee partner. See §1.704–4(e)(1) for a rule in the context of section 704(c)(1)(B). See also §1.737–3(b)(2) for a special rule for determining a partner’s adjusted tax basis in distributed property previously contributed by the partner to the partnership.

(ii) Advances or drawings. The distributee partner’s adjusted tax basis in the partnership interest is determined as of the last day of the partnership’s taxable year if the distribution to which section 737 applies is properly characterized as an advance or drawing against the partner’s distributive share of income. See §1.731–1(a)(1)(ii).

(c) Net precontribution gain—(1) General rule. The distributee partner’s net precontribution gain is the net gain (if any) that would have been recognized by the distributee partner under section 704(c)(1)(B) and §1.704–4 if all property that had been contributed to the partnership by the distributee partner within five years of the distribution and is held by the partnership immediately before the distribution had been distributed by the partnership to