§ 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.

(b) Excess distribution—(1) Definition. The excess distribution is the amount (if any) by which the fair market value of the distributed property (other than money) exceeds the distributee partner’s adjusted tax basis in the partner’s partnership interest.

(c) Fair market value of property. The fair market value of the distributed property is the price at which the property would change hands between a willing buyer and a willing seller at the time of the distribution, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. The fair market value that a partnership assigns to distributed property will be regarded as correct, provided that the value is reasonably agreed to among the partners in an arm’s-length negotiation and the partners have sufficiently adverse interests.

(3) Distributee partner’s adjusted tax basis—(i) General rule. In determining the amount of the excess distribution, the distributee partner’s adjusted tax basis in the partnership interest includes any basis adjustment resulting from the distribution that is subject to section 737 (for example, adjustments required under section 752) and from any other distribution or transaction that is part of the same distribution, except for—

(A) The increase required under section 737(c)(1) for the gain recognized by the partner under section 737; and

(B) The decrease required under section 737(2) for any property distributed to the 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
another partner other than a partner who owns, directly or indirectly, more than 50 percent of the capital or profits interest in the partnership. See §1.704–4 for provisions determining a contributing partner’s gain or loss under section 704(c)(1)(B) on an actual distribution of contributed section 704(c) property to another partner.

(2) Special rules—(i) Property contributed on or before October 3, 1989. Property contributed to the partnership on or before October 3, 1989, is not taken into account in determining a partner’s net precontribution gain. See §1.704–4(c)(1) for a similar rule in the context of section 704(c)(1)(B).

(ii) Section 734(b)(1)(A) adjustments. For distributions to a distributee partner of money by a partnership with a section 754 election in effect that are part of the same distribution as the distribution of property subject to section 737, for purposes of paragraph (a) and (c)(1) of this section the distributee partner’s net precontribution gain is reduced by the basis adjustments (if any) made to section 704(c) property contributed by the distributee partner under section 734(b)(1)(A). See §1.737–3(c)(4) for rules regarding basis adjustments for partnerships with a section 754 election in effect.

(iii) Transfers of a partnership interest. The transferee of all or a portion of a contributing partner’s partnership interest succeeds to the transferor’s net precontribution gain, if any, in an amount proportionate to the interest transferred. See §1.704–3(a)(7) and §1.704–4(d)(2) for similar provisions in the context of section 704(c)(1)(A) and section 704(c)(1)(B).

(iv) Section 704(c)(1)(B) gain recognized in related distribution. A distributee partner’s net precontribution gain is determined after taking into account any gain or loss recognized by the partner under section 704(c)(1)(B) and §1.704–4 (or that would have been recognized by the partner except for the like-kind exception in section 704(c)(2) and §1.704–4(d)(3)) on an actual distribution to another partner of section 704(c) property contributed by the distributee partner that is part of the same distribution as the distribution to the distributee partner.

(v) Section 704(c)(2) disregarded. A distributee partner’s net precontribution gain is determined without regard to the provisions of section 704(c)(2) and §1.704–4(d)(3) in situations in which the property contributed by the distributee partner is not actually distributed to another partner in a distribution related to the section 737 distribution.

(d) Character of gain. The character of the gain recognized by the distributee partner under section 737 and this section is determined by, and is proportionate to, the character of the partner’s net precontribution gain. For this purpose, all gains and losses on section 704(c) property taken into account in determining the partner’s net precontribution gain are netted according to their character. Character is determined at the partnership level for this purpose, and any character with a net negative amount is disregarded. The character of the partner’s gain under section 737 is the same as, and in proportion to, any character with a net positive amount. Character for this purpose is determined as if the section 704(c) property had been sold by the partnership to an unrelated third party at the time of the distribution and includes any item that would have been taken into account separately by the contributing partner under section 702(a) and §1.702–1(a).

(e) Examples. The following examples illustrate the provisions of this section. Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 737, and all partners are unrelated.


(ii) Property A has 10 years remaining on its cost recovery schedule and is depreciated
using the straight-line method. The partnership
uses the traditional method for allocating
items under section 704(c) described in
§1.704-3(b)(1) for Property A. The partnership
has book depreciation of $3,000 per year (10
percent of the $30,000 book basis in Property
A) and each partner is allocated $1,000 of book
depreciation per year (one-third of the total
book depreciation of $3,000). The partnership
also has tax depreciation of $2,000 per year
(10 percent of the $20,000 adjusted
tax basis in Property A). Thus, $2,000
tax depreciation is allocated equally between
B and C, the noncontributing partners with
respect to Property A.

(iii) At the end of 1997, the book value of
Property A is $21,000 ($30,000 initial book
value less $9,000 aggregate book depreci-
a tion) and its adjusted tax basis is $14,000
($20,000 initial tax basis less $6,000 aggregate
tax depreciation).

(iv) On December 31, 1997, Property B is
distributed to A in complete liquidation of
A’s partnership interest. The adjusted tax
basis of A’s partnership interest at that time
is $20,000. The amount of the excess distribu-
tion is $10,000, the difference between the fair
market value of the distributed Property B
($30,000) and A’s adjusted tax basis in A’s part-
nership interest ($20,000). A’s net precontribution gain is $7,000, the difference
between the book value of Property A
($21,000) and its adjusted tax basis at the
time of the distribution ($14,000). A recog-
nizes gain of $7,000 on the distribution, the
lesser of the excess distribution and the net
precontribution gain.

Example 2. Determination of distributee part-
ner’s basis. (i) On January 1, 1995, A, B, and C
form general partnership ABC as equal part-
ners. A contributes Property A, nondepre-
ciable real property with a fair market value
of $30,000, subject to a $9,000 non-
recourse liability. This nonrecourse liability
is allocated equally among the partners
under section 752, increasing A’s adjusted tax
basis in A’s partnership interest from $4,000
to $7,000.

(iii) On December 31, 1998, A receives $2,000
cash and Property B, subject to the $9,000 li-
ability, in a current distribution.

(iv) In determining the amount of the ex-
cess distribution, the adjusted tax basis of
A’s partnership interest is adjusted to take
into account the distribution of money and
the shift in liabilities. A’s adjusted tax basis
is therefore increased to $11,000 for this pur-
pose ($7,000 initial adjusted tax basis, less
$2,000 distribution of money, less $3,000 (de-
crease in A’s share of the $9,000 partnership
liability), plus $9,000 (increase in A’s indi-
vidual liabilities)). As a result of this basis
adjustment, the adjusted tax basis of A’s
partnership interest ($11,000) is greater than
the fair market value of the distributed
property ($9,000) and therefore, there is no
excess distribution. A recognizes no gain under
section 737.

Example 3. Net precontribution gain reduced
for gain recognized under section 704(c)(1)(B).
(i) On January 1, 1995, A, B, and C form part-
nership ABC as equal partners. A contributes
Properties A1 and A2, nondepreciable real
properties located in the United States each
with a fair market value of $10,000 and an ad-
justed tax basis of $6,000. B contributes Prop-
erty B, nondepreciable real property located
outside the United States, with a fair mar-
ket value and adjusted tax basis of $20,000. C
contributes $20,000 cash.

(ii) On December 31, 1998, Property B is dis-
tributed to A in complete liquidation of A’s part-
nership interest and, as part of the same distribu-
tion, Property A1 is distributed to B in a cur-
rent distribution.

(iii) A’s net precontribution gain before the
distribution is $6,000 ($20,000 fair market
value of Properties A1 and A2 less $12,000 ad-
justed tax basis of such properties). A recog-
nizes $4,000 of gain under section 704(c)(1)(B)
and §1.704-4 on the distribution of Property
A1 to B ($10,000 fair market value of Prop-
erty A1 less $6,000 adjusted tax basis of Prop-
erty A1). This gain is taken into account in
determining A’s excess distribution and net
precontribution gain. As a result, A’s net
precontribution gain is reduced from $6,000
to $4,000, and the adjusted tax basis of A’s
partnership interest is increased by $4,000 to
$16,000.

(iv) A recognizes gain of $4,000 on the re-
cipient of Property B under section 737, an
amount equal to the lesser of the excess dis-
tribution of $4,000 ($20,000 fair market value
of Property B less $16,000 adjusted tax basis
of A’s interest in the partnership) and A’s re-
aining net precontribution gain of $4,000.

Example 4. Character of gain. (i) On January 1,
1995, A, B, and C form partnership ABC as
equal partners. A contributes the following
nondepreciable property to the partnership:

<table>
<thead>
<tr>
<th>Property</th>
<th>Fair market value</th>
<th>Adjusted tax basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property A1</td>
<td>$30,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>Property A2</td>
<td>$30,000</td>
<td>$38,000</td>
</tr>
<tr>
<td>Property A3</td>
<td>$10,000</td>
<td>$9,000</td>
</tr>
</tbody>
</table>

(ii) The character of gain or loss on Prop-
erty A1 and Property A2 is long-term, U.S.-
sourced capital gain or loss. The character of
gain on Property A3 is long-term, foreign-
sourced capital gain. B contributes Property
B, nondepreciable real property with a fair
market value and adjusted tax basis of
$70,000. C contributes $70,000 cash.

(iii) On December 31, 1998, Property B is dis-
tributed to A in complete liquidation of
A’s interest in the partnership. A recognizes
$5,000 of gain under section 737, an amount
equal to the excess distribution of $3,000 ($70,000 fair market value of Property B less $67,000 adjusted tax basis in A’s partnership interest) and A’s net precontribution gain of $3,000 ($70,000 aggregate fair market value of properties contributed by A less $67,000 aggregate adjusted tax basis of such properties).

(iv) In determining the character of A’s gain, all gains and losses on property taken into account in determining A’s net precontribution gain are netted according to their character and allocated to A’s recognized gain under section 737 based on the relative proportions of the net positive amounts. U.S.-source and foreign-source gains must be netted separately because A would have been required to take such gains into account separately under section 702. As a result, A’s net precontribution gain of $3,000 consists of $2,000 of net long-term, U.S.-source capital gain ($10,000 gain on Property A1 and $8,000 loss on Property A2) and $1,000 of net long-term, foreign-source capital gain ($1,000 gain on Property A3).

(v) The character of A’s gain under paragraph (d) of this section is therefore $2,000 long-term, U.S.-source capital gain ($3,000 gain recognized under section 737 × $2,000 net long-term, U.S.-source capital gain) $3,000 total net precontribution gain) and $1,000 long-term, foreign-source capital gain ($3,000 gain recognized under section 737 × $1,000 net long-term, foreign-source capital gain). $3,000 total net precontribution gain).

[T.D. 9642, 60 FR 6733, Dec. 26, 1995]

§ 1.737–2 Exceptions and special rules.

(a) Section 708(b)(1)(B) terminations. Section 737 and this section do not apply to the deemed distribution of interests in a new partnership caused by the termination of a partnership under section 708(b)(1)(B). A subsequent distribution of property by the new partnership to a partner of the new partnership that was formerly a partner of the terminated partnership is subject to section 737 to the same extent that a distribution from the terminated partnership would have been subject to section 737. See also §1.704–4(c)(3) for a similar rule in the context of section 704(c)(1)(B). This paragraph (a) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, this paragraph (a) may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply this paragraph (a) to the termination in a consistent manner.

(b) Transfers to another partnership—

(1) Complete transfer. Section 737 and this section do not apply to a transfer by a partnership (transferor partnership) of all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement. See §1.704–4(c)(4) for a similar rule in the context of section 704(c)(1)(B).

(2) Certain divisive transactions. Section 737 and this section do not apply to a transfer by a partnership (transferor partnership) of all of the section 704(c) property contributed by a partner to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution as part of the same plan or arrangement of an interest in the transferee partnership (and no other property) in complete liquidation of the interest of the partner that originally contributed the section 704(c) property to the transferor partnership.

(3) Subsequent distributions. A subsequent distribution of property by the transferee partnership to a partner of the transferee partnership that was formerly a partner of the transferor partnership is subject to section 737 to the same extent that a distribution from the transferor partnership would have been subject to section 737.

(c) Incorporation of a partnership. Section 737 and this section do not apply to an incorporation of a partnership by any method of incorporation (other than a method involving an actual distribution of partnership property to the partners followed by a contribution of that property to a corporation), provided that the partnership is liquidated as part of the incorporation transaction. See §1.704–4(c)(5) for a similar rule in the context of section 704(c)(1)(B).

(d) Distribution of previously contributed property—

(1) General rule. Any portion of the distributed property that consists of property previously contributed by the distributee partner (previously contributed property) is not taken into account in determining the amount of the excess distribution or