

statutory language and the legislative history. The proposed regulations also contain special rules dealing with specific situations such as the partnership's exchange of the contributed property for other property in a nonrecognition transaction and the transfer of a contributing partner's interest in the partnership. The proposed regulations also provide for coordination between section 704(c)(1)(B) and section 737 in situations in which both sections may apply to a distribution or distributions by a partnership. In fashioning these specific rules, the proposed regulations focus on the purpose of section 704(c)(1)(B) and section 737, rather than simply relying on the literal language of the provisions in situations that would be inconsistent with the underlying purpose of the provisions.

The proposed regulations under section 704(c)(1)(B) and section 737 contain an anti-abuse rule providing that the rules of the applicable section must be applied in a manner consistent with its purpose. Accordingly, the anti-abuse rules contained in the proposed regulations provide that, if a principal purpose of a transaction is to achieve a tax result inconsistent with the purpose of the applicable section, the Commissioner can recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with such purpose.

Whether a tax result is inconsistent with the purpose of the applicable section is determined based on all the facts and circumstances. The proposed regulations also provide examples illustrating how these anti-abuse rules apply.

#### *B. Section 704(c)(1)(B)*

##### *In General*

Under the proposed regulations, the contributing partner must recognize gain or loss on a distribution of the contributed property to another partner within five years of its contribution to the partnership. The amount of gain or loss recognized is the amount that would have been allocated to the contributing partner under section 704(c)(1)(A) and § 1.704-3 if the distributed property had been sold by the partnership to the distributee partner at its fair market value at the time of the distribution. The amount of gain or loss recognized may vary depending on the particular method used by the partnership in making allocations under section 704(c)(1)(A) and § 1.704-3 because the amount of remaining built-in gain or loss may vary depending on the particular method of

allocation adopted. In addition, because the property is treated as having been sold by the partnership to the distributee partner, the proposed regulations provide that any loss that would have been disallowed under section 707(b)(1) if the distributed property had actually been sold to the distributee partner is disallowed.

##### *Five-Year Period*

Section 704(c)(1)(B) applies only to property distributed within five years of its contribution to the partnership. The proposed regulations provide that a new five-year period begins for property deemed contributed to a new partnership following a termination of the partnership under section 708(b)(1)(B), but only to the extent that the pre-termination gain or loss on such property was not already required to be allocated to the original contributor under section 704(c)(1)(A) and § 1.704-3. The effect of this provision is to begin a new five-year period for post-contribution changes in the value of partnership property whenever there is a termination of the partnership under section 708(b)(1)(B). This provision is consistent with the legislative history of section 704(c)(1)(B).

##### *Character of Gain or Loss*

The proposed regulations provide that the character of the contributing partner's gain or loss is the same as the character that would have been recognized if the property had been sold by the partnership to the distributee partner. Thus, if the distributee partner holds more than a 50 percent capital or profits interest in the partnership, any gain recognized by the contributing partner may be ordinary income under section 707(b)(2).

##### *Exceptions and Special Rules*

The proposed regulations provide that section 704(c)(1)(B) does not apply to (i) a distribution of property contributed to the partnership on or before October 3, 1989, or (ii) a distribution of property in connection with a termination of the partnership under section 708(b)(1)(B). The proposed regulations also provide that section 704(c)(1)(B) does not apply to a distribution of a portion of contributed property to a noncontributing partner in a complete liquidation of the partnership if a portion of the contributed property is distributed to the contributing partner and that portion has unrecognized gain or loss in the hands of the contributing partner, determined immediately after the distribution, at least equal to the built-in gain or loss that would have been allocated to the contributing

partner under section 704(c)(1)(A) on a sale of the contributed property by the partnership at the time of the distribution. This exception is consistent with the purpose of section 704(c)(1)(B) to prevent the shifting of built-in gain or loss among partners because no shift has occurred in this limited situation.

The proposed regulations provide that property received by a partnership in exchange for contributed property in a nonrecognition transaction is treated as the contributed property. This result is consistent with the rule under § 1.704-3(a)(8) of the regulations. The proposed regulations also provide that the transferee of a contributing partner is treated as the contributing partner to the extent of the built-in gain or loss allocated to the transferee partner. The gain or loss allocated to the transferee partner may be offset, however, by the basis adjustments to partnership property by a partnership with a section 754 election in effect. This result is consistent with the result under § 1.704-3(a)(7) of the regulations.

The proposed regulations also provide a special rule under section 704(c)(2) for cases in which the contributing partner receives like-kind property no later than the earlier of: (1) 180 days following the date of the distribution of contributed property to another partner, or (2) the due date (determined with regard to extensions) of the contributing partner's income tax return for the taxable year of the distribution to the other partner. Under this rule, the contributing partner's gain that otherwise would be recognized under section 704(c)(1)(B) is reduced by the amount of built-in gain or loss in the distributed like-kind property in the hands of the contributing partner. The amount of the built-in gain or loss is determined by reference to the contributing partner's basis in the property immediately after the distribution under section 732(a) or (b). The proposed regulations provide that the basis in the distributed like-kind property in this situation is determined without taking into account any increase in the basis of the contributing partner's partnership interest for any gain recognized under section 704(c)(1)(B). This special rule implements the statutory objective of not requiring gain or loss on distributions where gain or loss would not have been recognized outside of a partnership. When gain or loss is not recognized in exchanges of like-kind property outside of partnerships, the built-in gain or loss on the exchanged property is generally preserved in the property received in the exchange. To the extent that this built-in gain or loss