

is not preserved in the case of a distribution of property by the partnership, the exception does not apply.

Basis Adjustments

The contributing partner's basis in the partnership interest and the partnership's basis in the distributed property are increased or decreased by the amount of gain or loss recognized by the contributing partner. These adjustments are taken into account in determining (1) the noncontributing partner's basis in the property distributed to that partner, (2) the contributing partner's basis in any property distributed to that partner in the same transaction (except to the extent that the distributed property is like-kind property subject to the special rule discussed above), (3) the basis adjustments, if any, to partnership property by a partnership with a section 754 election in effect, and (4) the amount of the contributing partner's gain under section 731 or section 737 on a related distribution of money or property, respectively, to the contributing partner.

C. Section 737

In General

Under the proposed regulations, a partner that contributes property with built-in gain to a partnership and receives a distribution of property other than money within five years of that contribution must recognize gain in an amount equal to the lesser of (1) the excess (if any) of the fair market value of the distributed property over the adjusted basis of the partner's interest in the partnership (excess distribution); or (2) the net precontribution gain of the partner.

Excess Distribution

In determining the amount of the excess distribution, the proposed regulations provide that the distributee partner's adjusted basis in the partnership interest is first adjusted for all basis adjustments resulting from the distribution subject to section 737 (for example, basis adjustments under section 752) and any basis adjustments resulting from any other distribution that is part of the same plan or arrangement (for example, basis adjustments required under sections 704(c)(1)(B) and 751(b)). Two basis adjustments, however, are not taken into account in determining whether there is an excess distribution: (1) the partner's basis is not increased for the gain recognized under section 737, and (2) is not decreased by the adjustment

required under section 733 for property distributed to the distributee partner in the transaction (other than property previously contributed to the partnership by the partner). The first exception is consistent with section 737(c)(1) and the second is necessary to prevent an inappropriate decrease in the partner's basis (and corresponding increase in the partner's gain) under section 737. The reduction in the partner's adjusted basis for a distribution of property previously contributed to the partnership by the partner is necessary to give effect to the statutory requirement that a distribution of previously contributed property not be taken into account in determining the amount of an excess distribution.

The proposed regulations also provide that, in determining the amount of an excess distribution, the fair market value of distributed property is not reduced by the amount of any liability assumed or taken subject to by the partner. The distributee partner's basis in the partnership interest, however, is increased by the amount of any liability assumed or taken subject to by the distributee partner and this increase is taken into account in determining the amount of the excess distribution. (The partner's basis is also adjusted for the decrease in the partner's share of partnership liabilities as a result of the distribution for this purpose.) As a result, the gross fair market value of the property will be offset by the basis increase in the partner's interest in the partnership under section 752 and, as a result, the amount of the excess distribution should be limited to the net value of the distributed property.

Net Precontribution Gain

The distributee partner's net precontribution gain is the net gain (if any) that the partner would have recognized under section 704(c)(1)(B) if the partnership had distributed to another partner all property contributed to the partnership by the distributee partner within five years of the date of the distribution. The amount of gain or loss that the distributee partner would recognize under section 704(c)(1)(B) is determined under the proposed regulations to section 704(c)(1)(B) contained in this notice.

The proposed regulations under section 737 provide special rules for determining the amount of the partner's net precontribution gain. Property contributed on or before October 3, 1989, is not included in determining the amount of net precontribution gain because net precontribution gain is determined by reference to section 704(c)(1)(B), and that section does not

apply to property contributed to the partnership on or before October 3, 1989.

Net precontribution gain is reduced as a result of a basis increase to the contributed property under section 734(b)(1)(A) to reflect gain recognized by the partner under section 731 on a distribution of money in the same plan or arrangement as the distribution of property subject to section 737. This reduction is appropriate because some or all of the precontribution gain is recognized by the contributing partner under section 731 on the distribution.

The proposed regulations also provide that a transferee partner succeeds to the transferor's net precontribution gain in an amount proportionate to the interest transferred. This provision is consistent with the provision in § 1.704-3(a)(7) (and § 1.704-4(d)(2) of the proposed regulations) requiring a transferee partner to succeed to all or a portion of the transferor's built-in gain or loss. The transferee partner, however, may not recognize the same amount of gain that the transferor partner would have recognized on a subsequent distribution because the transferee's basis in the partnership interest may be higher or lower than the transferor's basis, and the amount of gain allocated to the transferee partner under section 704(c)(1)(A) will be affected by any basis adjustment required under section 754.

Net precontribution gain is also reduced by the amount of gain recognized by the contributing partner under section 704(c)(1)(B) in a distribution of contributed property in a related distribution to another partner, and by the amount of gain that the partner would have recognized under section 704(c)(1)(B) on the distribution of contributed property to another partner but for the exception of section 704(c)(2). This reduction is necessary to avoid gain recognition under both section 704(c)(1)(B) and section 737 with respect to the same built-in gain. The reduction for gain not recognized as a result of the section 704(c)(2) exception only applies in situations where there is an actual distribution of contributed property to another partner.

Character of Gain

The character of the contributing partner's recognized gain is determined by reference to the character of the partner's net precontribution gain. The character of such gain is determined by netting all of the precontribution gains and losses according to the character that such property would have had on a sale by the partnership to an unrelated third party. The character of the