

contributing partner's gain under section 737 is the same (and in the same proportion) as the character of any net positive amounts resulting from the netting of the precontribution gains and losses. Character for this purpose is broadly defined in the proposed regulations to include any item that the contributing partner would have been required to take into account separately under section 702(a) and § 1.702-1(a) had the partnership sold all the property contributed by that partner.

Because the contributed property is not actually transferred by the partnership to any particular partner, it is appropriate to treat the hypothetical dispositions by the partnership as occurring with an unrelated third party. As a result, the character conversion rule of section 707(b)(2) does not apply for purposes of determining the character of the distributee partner's gain. (Compare section 704(c)(1)(B) and § 1.704-4(b)(1) in which the character conversion rule does apply because the contributed property is actually distributed to another partner.)

Exceptions and Special Rules

The proposed regulations provide that section 737 does not apply to a deemed distribution of property on a termination of the partnership under section 708(b)(1)(B). As noted above (with respect to the discussion of the proposed regulations under section 704(c)(1)(B)), however, a new five-year period begins for property to the extent that the pre-termination gains and losses, if any, were not already required to be allocated to the original contributor under section 704(c)(1)(A) and § 1.704-3.

A transferee partner in a transfer that causes a termination under section 708(b)(1)(B) will generally not have any net precontribution gain immediately after the deemed formation of the new partnership. The basis of the property deemed contributed by the transferee partner to the new partnership is determined under section 732 and, as a result, the transferee partner may be treated as having contributed built-in gain and built-in loss property to the new partnership. These built-in gain and loss properties, however, should net to zero, assuming that the transferee partner's total basis in the properties is equal to their total fair market value. Section 737, however, does apply to the transferee partner and could result in gain recognition on a subsequent distribution if the distribution occurs at a time when the partner has a net precontribution gain. The transferee partner could have a net precontribution gain on a subsequent distribution if, for

example, the partnership sells some or all of the built-in loss property (that is deemed contributed by that partner to the new partnership in the section 708(b)(1)(B) termination) and retains the built-in gain property.

The proposed regulations also provide that section 737 does not apply to partnership mergers and similar transactions because the partners have merely converted their interests in the transferor partnership to an interest in the transferee partnership. As a result of this treatment, however, distributions by the transferee partnership are subject to section 737 to the same extent that distributions from the transferor partnership would have been subject to section 737.

Under the proposed regulations, section 737 applies to an incorporation of the partnership involving an actual distribution of property by the partnership to the partners followed by a contribution to a corporation. (As discussed below, however, section 737 does not apply to the extent that the property actually distributed to a partner was previously contributed to the partnership by that partner.) Section 737 does not apply to an incorporation of a partnership by methods not involving an actual distribution of partnership property to the partners, provided that the incorporation is followed by a complete liquidation of the partnership as part of the same plan or arrangement as the incorporation. Section 737 does not apply in these situations because the partners are converting their partnership interests into a stock interest in the corporation in a nonrecognition transaction and, under the rules of either sections 732 or 358, the built-in gain in a partner's partnership interest is preserved in the stock received by the contributing partner. This exception is similar to the general carry-over treatment provided in § 1.704-3(a)(8) for section 704(c) property exchanged in a nonrecognition transaction. Incorporation by means of a distribution of partnership property to the partners also results in the same conversion of a partnership interest into stock of a corporation, but that method of incorporation involves an actual distribution of property to the partners and the form of incorporation chosen by the partners governs the tax consequences of incorporation, including the application of section 737.

The proposed regulations provide that a related distribution of property previously contributed to the partnership by the distributee partner is not taken into account in determining the amount of the excess distribution or the partner's net precontribution gain.

The proposed regulations also provide, consistent with section 737(d)(1), for a limitation in the case of a distribution of a previously contributed interest in an entity. This limitation is intended to prevent a partner from avoiding section 737 by contributing an interest in an entity to the partnership and having the partnership contribute property to that entity, followed by a distribution of an interest in the entity to the contributing partner under the previously contributed property exception. This limitation does not apply to the extent that the property contributed by the partnership to the entity was contributed by the same partner that contributed the interest in the entity because, in that case, the distributee partner is receiving only a distribution of property that it previously contributed to the partnership.

The proposed regulations also provide that any property received by the partnership in exchange for previously contributed property is treated as previously contributed property to the extent such property is treated as section 704(c) property with regard to the contributing partner under § 1.704-3(a)(8). This provision is consistent with the general treatment of nonrecognition transactions involving section 704(c) property under § 1.704-3(a)(8).

Basis Adjustments

The contributing partner's basis in the partnership interest is increased by the amount of gain recognized by the partner. This increase is taken into account in determining a partner's basis in property received by that partner, but is not taken into account in determining the amount of gain recognized by the partner under section 737 or the amount of gain recognized under section 731 on any distribution of money in the same distribution as the distribution of property subject to section 737.

The partnership's basis in property contributed by the partner is also increased by the gain recognized by the partner. The basis increase is limited to built-in gain property held by the partnership after the distribution with the same character as the character of the gain recognized by the contributing partner under section 737. No basis increase is allocated to any previously contributed property that is part of the distribution to which section 737 applied. This previously contributed property is not taken into account in determining the amount of net precontribution gain and therefore it is not appropriate to increase the basis of that property. There is also no basis increase to any property distributed to another partner in a related distribution