

(one-third 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, consisting 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 partnership 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 \$3,667 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 partnership agreement provides 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, plus \$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 item of section 1245 property (as defined in section 1245(a)(3)). Assume further that under paragraph (c)(4) of § 1.751-1 the section 1245 property is an unrealized receivable to the extent of \$2,000. Therefore, the value of A's interest in section 736(b) partnership property is only \$11,333 (one-third of \$34,000, the sum of \$13,000 cash and \$21,000, the fair market value of section 1245 property to the extent not an unrealized receivable). From the disposition of his interest in partnership property, A will realize a capital gain of \$333 (\$11,333 minus \$11,000, the basis of his interest). The remaining \$18,667 (\$30,000 minus \$11,333) will constitute payments under section 736(a)(2) which are taxable to A as guaranteed payments under section 707(c).

(c) *Cross reference.* See section 753 for treatment of payments under section 736(a) as income in respect of a decedent under section 691.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6832, 30 FR 8574, July 7, 1965]

#### § 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 acting in the capacity of a partner within the meaning of section 731, except that section 737 and this section do not apply to the extent

that section 751(b) applies to the distribution.

(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.

(2) *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 733(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.

*Example 1.* Calculation of excess distribution and net precontribution gain. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, depreciable real property with a fair market value of \$30,000 and an adjusted tax basis of \$20,000. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of \$30,000. C contributes \$30,000 cash.

(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 annual 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). This \$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 depreciation) 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 distribution 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 partnership 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 recognizes gain of \$7,000 on the distribution, the lesser of the excess distribution and the net precontribution gain.

*Example 2. Determination of distributee partner's basis.* (i) On January 1, 1995, A, B, and C form general partnership ABC as equal partners. A contributes Property A, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$4,000. B and C each contributes \$10,000 cash.

(ii) The partnership purchases Property B, nondepreciable real property with a fair market value of \$9,000, subject to a \$9,000 nonrecourse 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 liability, in a current distribution.

(iv) In determining the amount of the excess 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 purpose (\$7,000 initial adjusted tax basis, less \$2,000 distribution of money, less \$3,000 (decrease in A's share of the \$9,000 partnership liability), plus \$9,000 (increase in A's individual 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 partnership 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 adjusted tax basis of \$6,000. B contributes Property B, nondepreciable real property located outside the United States, with a fair market value and adjusted tax basis of \$20,000. C contributes \$20,000 cash.

(ii) On December 31, 1998, Property B is distributed to A in complete liquidation of A's interest and, as part of the same distribution, Property A1 is distributed to B in a current distribution.

(iii) A's net precontribution gain before the distribution is \$8,000 (\$20,000 fair market value of Properties A1 and A2 less \$12,000 adjusted tax basis of such properties). A recognizes \$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 Property A1 less \$6,000 adjusted tax basis of Property 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 \$8,000 to \$4,000, and the adjusted tax basis in A's partnership interest is increased by \$4,000 to \$16,000.

(iv) A recognizes gain of \$4,000 on the receipt of Property B under section 737, an amount equal to the lesser of the excess distribution 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 remaining 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:

	Fair market value	Adjusted tax basis
Property A1 .....	\$30,000	\$20,000
Property A2 .....	30,000	38,000
Property A3 .....	10,000	9,000

(ii) The character of gain or loss on Property A1 and Property A2 is long-term, U.S.-source capital gain or loss. The character of gain on Property A3 is long-term, foreign-source 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 distributed to A in complete liquidation of A's interest in the partnership. A recognizes \$3,000 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. 8642, 60 FR 66733, 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