

treated as contributed by the distributee partner, is reduced to the extent of the undivided interest distributed to the distributee partner.

(e) *Examples.* The following examples illustrate the rules 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. Distribution of previously contributed property. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes the following nondepreciable real property to the partnership:

	Fair market value	Adjusted tax basis
Property A1	\$20,000	\$10,000
Property A2	10,000	6,000

(ii) A's total net precontribution gain on the contributed property is \$14,000 (\$10,000 on Property A1 plus \$4,000 on Property A2). B contributes \$10,000 cash and Property B, nondepreciable real property with a fair market value and adjusted tax basis of \$20,000. C contributes \$30,000 cash.

(iii) On December 31, 1998, Property A2 and Property B are distributed to A in complete liquidation of A's interest in the partnership. Property A2 was previously contributed by A and is therefore not taken into account in determining the amount of the excess distribution or A's net precontribution gain. The adjusted tax basis of Property A2 in the hands of A is also determined under section 732 as if that property were the only property distributed to A.

(iv) As a result of excluding Property A2 from these determinations, the amount of the excess distribution is \$10,000 (\$20,000 fair market value of distributed Property B less \$10,000 adjusted tax basis in A's partnership interest). A's net precontribution gain is also \$10,000 (\$14,000 total net precontribution gain less \$4,000 gain with respect to previously contributed Property A2). A therefore recognizes \$10,000 of gain on the distribution, the lesser of the excess distribution and the net precontribution gain.

Example 2. Distribution of a previously contributed interest in an entity. (i) On January 1, 1995, A, B, and C form 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 \$5,000, and all of the stock of Corporation X with a fair market value and adjusted tax

basis of \$500. B contributes \$500 cash and Property B, nondepreciable real property with a fair market value and adjusted tax basis of \$10,000. Partner C contributes \$10,500 cash. On December 31, 1996, ABC contributes Property B to Corporation X in a non-recognition transaction under section 351.

(ii) On December 31, 1998, all of the stock of Corporation X is distributed to A in complete liquidation of A's interest in the partnership. The stock is treated as previously contributed property with respect to A only to the extent of the \$500 fair market value of the Corporation X stock contributed by A. The fair market value of the distributed stock for purposes of determining the amount of the excess distribution is therefore \$10,000 (\$10,500 total fair market value of Corporation X stock less \$500 portion treated as previously contributed property). The \$500 fair market value and adjusted tax basis of the Corporation X stock is also not taken into account in determining the amount of the excess distribution and the net precontribution gain.

(iii) A recognizes \$5,000 of gain under section 737, the amount of the excess distribution (\$10,000 fair market value of distributed property less \$5,000 adjusted tax basis in A's partnership interest) and A's net precontribution gain (\$10,000 fair market value of Property A less \$5,000 adjusted tax basis in Property A).

Example 3. Distribution of undivided interest in property. (i) On January 1, 1995, A and B form partnership AB as equal partners. A contributes \$500 cash and an undivided one-half interest in Property X. B contributes \$500 cash and an undivided one-half interest in Property X.

(ii) On December 31, 1998, an undivided one-half interest in Property X is distributed to A in a current distribution. The distribution of the undivided one-half interest in Property X is treated as a distribution of previously contributed property because A contributed an undivided one-half interest in Property X. As a result, A does not recognize any gain under section 737 on the distribution.

[T.D. 8642, 60 FR 66735, Dec. 26, 1995, as amended by T.D. 8717, 62 FR 25501, May 9, 1997]

§ 1.737-3 Basis adjustments; Recovery rules.

(a) *Distributee partner's adjusted tax basis in the partnership interest.* The distributee partner's adjusted tax basis in the partnership interest is increased by the amount of gain recognized by the distributee partner under section 737 and this section. This increase is not taken into account in determining the

amount of gain recognized by the partner under section 737(a)(1) and this section or in determining the amount of gain recognized by the partner under section 731(a) on the distribution of money in the same distribution or any related distribution. See §1.704-4(e)(1) for a determination of the distributee partner's adjusted tax basis in a distribution subject to section 704(c)(1)(B).

(b) *Distributee partner's adjusted tax basis in distributed property*—(1) *In general.* The distributee partner's adjusted tax basis in the distributed property is determined under section 732 (a) or (b) as applicable. The increase in the distributee partner's adjusted tax basis in the partnership interest under paragraph (a) of this section is taken into account in determining the distributee partner's adjusted tax basis in the distributed property other than property previously contributed by the partner. See §1.704-4(e)(2) for a determination of basis in a distribution subject to section 704(c)(1)(B).

(2) *Previously contributed property.* The distributee partner's adjusted tax basis in distributed property that the partner previously contributed to the partnership is determined as if it were distributed in a separate and independent distribution prior to the distribution that is subject to section 737 and §1.737-1.

(c) *Partnership's adjusted tax basis in partnership property*—(1) *Increase in basis.* The partnership's adjusted tax basis in eligible property is increased by the amount of gain recognized by the distributee partner under section 737.

(2) *Eligible property.* Eligible property is property that—

(i) Entered into the calculation of the distributee partner's net precontribution gain;

(ii) Has an adjusted tax basis to the partnership less than the property's fair market value at the time of the distribution;

(iii) Would have the same character of gain on a sale by the partnership to an unrelated party as the character of any of the gain recognized by the distributee partner under section 737; and

(iv) Was not distributed to another partner in a distribution subject to section 704(c)(1)(B) and §1.704-4 that was

part of the same distribution as the distribution subject to section 737.

(3) *Method of adjustment.* For the purpose of allocating the basis increase under paragraph (c)(2) of this section among the eligible property, all eligible property of the same character is treated as a single group. Character for this purpose is determined in the same manner as the character of the recognized gain is determined under §1.737-1(d). The basis increase is allocated among the separate groups of eligible property in proportion to the character of the gain recognized under section 737. The basis increase is then allocated among property within each group in the order in which the property was contributed to the partnership by the partner, starting with the property contributed first, in an amount equal to the difference between the property's fair market value and its adjusted tax basis to the partnership at the time of the distribution. For property that has the same character and was contributed in the same (or a related) transaction, the basis increase is allocated based on the respective amounts of unrealized appreciation in such properties at the time of the distribution.

(4) *Section 754 adjustments.* The basis adjustments to partnership property made pursuant to paragraph (c)(1) of this section are not elective and must be made regardless of whether the partnership has an election in effect under section 754. Any adjustments to the bases of partnership property (including eligible property as defined in paragraph (c)(2) of this section) under section 734(b) pursuant to a section 754 election (other than basis adjustments under section 734(b)(1)(A) described in the following sentence) must be made after (and must take into account) the adjustments to basis made under paragraph (a) and paragraph (c)(1) of this section. Basis adjustments under section 734(b)(1)(A) that are attributable to distributions of money to the distributee partner that are part of the same distribution as the distribution of property subject to section 737 are made before the adjustments to basis under paragraph (a) and paragraph (c)(1) of this section. See §1.737-1(c)(2)(ii) for the effect, if any, of basis

adjustments under section 734(b)(1)(A) on a partner's net precontribution gain. See also §1.704-4(e)(3) for a similar rule regarding basis adjustments pursuant to a section 754 election in the context of section 704(c)(1)(B).

(d) *Recovery of increase to adjusted tax basis.* Any increase to the adjusted tax basis of partnership property under paragraph (c)(1) of this section is recovered using any applicable recovery period and depreciation (or other cost recovery) method (including first-year conventions) available to the partnership for newly purchased property (of the type adjusted) placed in service at the time of the distribution.

(e) *Examples.* The following examples illustrate the rules 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. Partner's basis in distributed property. (i) On January 1, 1995, A, B, and C form 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 \$5,000. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of \$10,000. C contributes \$10,000 cash.

(ii) On December 31, 1998, Property B is distributed 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 \$5,000 (\$10,000 fair market value of Property B less \$5,000 adjusted tax basis in A's partnership interest) and A's net precontribution gain of \$5,000 (\$10,000 fair market value of Property A less \$5,000 adjusted tax basis of such property).

(iii) A's adjusted tax basis in A's partnership interest is increased by the \$5,000 of gain recognized under section 737. This increase is taken into account in determining A's basis in the distributed property. Therefore, A's adjusted tax basis in distributed Property B is \$10,000 under section 732(b).

Example 2. Partner's basis in distributed property in connection with 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 the following nondepreciable real property located in the United States to the partnership:

	Fair market value	Adjusted tax basis
Property A1	\$10,000	5,000
Property A2	10,000	2,000

(ii) B contributes \$10,000 cash and Property B, nondepreciable real property located outside the United States, with a fair market value and adjusted tax basis of \$10,000. C contributes \$20,000 cash.

(iii) On December 31, 1998, Property B is distributed to A in a current distribution and Property A1 is distributed to B in a current distribution. A recognizes \$5,000 of gain under section 704(c)(1)(B) and §1.704-4 on the distribution of Property A1 to B, the difference between the fair market value of such property (\$10,000) and the adjusted tax basis in distributed Property A1 (\$5,000). The adjusted tax basis of A's partnership interest is increased by this \$5,000 of gain under section 704(c)(1)(B) and §1.704-4(e)(1).

(iv) The increase in the adjusted tax basis of A's partnership interest is taken into account in determining the amount of the excess distribution. As a result, there is no excess distribution because the fair market value of Property B (\$10,000) is less than the adjusted tax basis of A's interest in the partnership at the time of distribution (\$12,000). A therefore recognizes no gain under section 737 on the receipt of Property B. A's adjusted tax basis in Property B is \$10,000 under section 732(a)(1). The adjusted tax basis of A's partnership interest is reduced from \$12,000 to \$2,000 under section 733. See *Example 3* of §1.737-1(e).

Example 3. Partnership's basis in partnership property after a distribution with section 737 gain. (i) On January 31, 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	\$1,000	\$500
Property A2	4,000	1,500
Property A3	4,000	6,000
Property A4	6,000	4,000

(ii) The character of gain or loss on Properties A1, A2, and A3 is long-term, U.S.-source capital gain or loss. The character of gain on Property A4 is long-term, foreign-source capital gain. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of \$15,000. C contributes \$15,000 cash.

(iii) On December 31, 1998, Property B is distributed to A in complete liquidation of A's interest in the partnership. A recognizes gain of \$3,000 under section 737, an amount equal to the excess distribution of \$3,000 (\$15,000 fair market value of Property B less \$12,000 adjusted tax basis in A's partnership

interest) and A's net precontribution gain of \$3,000 (\$15,000 aggregate fair market value of the property contributed by A less \$12,000 aggregate adjusted tax basis of such property).

(iv) \$2,000 of A's gain is long-term, foreign-source capital gain (\$3,000 total gain under section 737 × \$2,000 net long-term, foreign-source capital gain/\$3,000 total net precontribution gain). \$1,000 of A's gain is long-term, U.S.-source capital gain (\$3,000 total gain under section 737 × \$1,000 net long-term, U.S.-source capital gain/\$3,000 total net precontribution gain).

(v) The partnership must increase the adjusted tax basis of the property contributed by A by \$3,000. All property contributed by A is eligible property. Properties A1, A2, and A3 have the same character and are grouped into a single group for purposes of allocating this basis increase. Property A4 is in a separate character group.

(vi) \$2,000 of the basis increase must be allocated to long-term, foreign-source capital assets because \$2,000 of the gain recognized by A was long-term, foreign-source capital gain. The adjusted tax basis of Property A4 is therefore increased from \$4,000 to \$6,000. \$1,000 of the increase must be allocated to Properties A1 and A2 because \$1,000 of the gain recognized by A is long-term, U.S.-source capital gain. No basis increase is allocated to Property A3 because its fair market value is less than its adjusted tax basis. The \$1,000 basis increase is allocated between Properties A1 and A2 based on the unrealized appreciation in each asset before such basis adjustment. As a result, the adjusted tax basis of Property A1 is increased by \$167 (\$1,000×\$500/\$3,000) and the adjusted tax basis of Property A2 is increased by \$833 (\$1,000×\$2,500/3,000).

[T.D. 8642, 60 FR 66736, Dec. 26, 1995; 61 FR 7214, Feb. 27, 1996]

§ 1.737-4 Anti-abuse rule.

(a) *In general.* The rules of section 737 and §§ 1.737-1, 1.737-2, and 1.737-3 must be applied in a manner consistent with the purpose of section 737. Accordingly, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 737, the Commissioner can recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with the purpose of section 737. Whether a tax result is inconsistent with the purpose of section 737 must be determined based on all the facts and circumstances. See § 1.704-4(f) for an anti-abuse rule and examples in the context of section 704(c)(1)(B). The anti-abuse rule and examples under

section 704(c)(1)(B) and § 1.704-4(f) are relevant to section 737 and §§ 1.737-1, 1.737-2, and 1.737-3 to the extent that the net precontribution gain for purposes of section 737 is determined by reference to section 704(c)(1)(B).

(b) *Examples.* The following examples illustrate the rules of this section. The examples set forth below do not delineate the boundaries of either permissible or impermissible types of transactions. Further, the addition of any facts or circumstances that are not specifically set forth in an example (or the deletion of any facts or circumstances) may alter the outcome of the transaction described in the example. 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. Increase in distributee partner's basis by temporary contribution; results inconsistent with the purpose of section 737. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A1, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$1,000. B contributes Property B, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$10,000. C contributes \$10,000 cash.

(ii) On January 1, 1999, pursuant to a plan a principal purpose of which is to avoid gain under section 737, A transfers to the partnership Property A2, nondepreciable real property with a fair market value and adjusted tax basis of \$9,000. A treats the transfer as a contribution to the partnership pursuant to section 721 and increases the adjusted tax basis of A's partnership interest from \$1,000 to \$10,000. On January 1, 1999, the partnership agreement is amended and all other necessary steps are taken so that substantially all of the economic risks and benefits of Property A2 are retained by A. On February 1, 1999, Property B is distributed to A in a current distribution. If the contribution of Property A2 is treated as a contribution to the partnership for purposes of section 737, there is no excess distribution because the fair market value of distributed Property B (\$10,000) does not exceed the adjusted tax basis of A's interest in the partnership (\$10,000), and therefore section 737 does not apply. A's adjusted tax basis in distributed Property B is \$10,000 under section 732(a)(1)