

**DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1**

**Distribution of Marketable
Securities by a Partnership**

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations providing rules for partnership distributions of marketable securities under section 731(c) of the Internal Revenue Code of 1986, as amended, and for determining when those distributions are taxable to the distributee partner. The regulations reflect changes to the law made by the Uruguay Round Agreements Act enacted on December 8, 1994.

DATES: These regulations are effective on December 26, 1996.

FOR FURTHER INFORMATION CONTACT: Terri A. Belanger or William M. Kostak at (202) 622-3080 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document amends 26 CFR part 1 to provide rules relating to the treatment of partnership distributions of marketable securities under section 731(c). Under section 731(a), in the case of a distribution by a partnership to a partner, gain is recognized to the partner only to the extent that any money distributed exceeds the adjusted basis of the partner's interest in the partnership. Prior to the enactment of section 731(c), marketable securities were not considered money and, therefore, the distribution of marketable securities by a partnership to a partner was not a taxable event. Section 731(c) now treats a partnership distribution of marketable securities as a distribution of money and as a taxable event if the value of the distributed securities exceeds the adjusted basis of the partner's interest in the partnership. Section 731(c) also provides several exceptions to the general

rule that a distribution of marketable securities will be treated as a distribution of money.

On January 2, 1996, the IRS published in the **Federal Register** (61 FR 28) a notice of proposed rulemaking (PS-2-95) to provide guidance regarding section 731(c). A number of public comments were received concerning the proposed regulations. However, the public hearing scheduled for April 3, 1996, was cancelled because no one requested to speak. After consideration of the written comments received, the proposed regulations are adopted as revised by this Treasury decision.

Explanation of Provisions

I. General background

The proposed regulations provide rules for determining when and the extent to which a distribution of marketable securities by a partnership to a partner will be treated as a distribution of money for purposes of section 731(a). Although modified in response to comments, the final regulations generally adopt the rules contained in the proposed regulations.

II. Public comments

Several comments requested that the IRS reconsider the requirement in § 1.731-2(d)(2)(ii) of the proposed regulations that a marketable security must be actively traded on the date of distribution to qualify for the “nonrecognition transaction” exception to section 731(c). Because of this rule, financial instruments (securities) that are treated as marketable securities under section 731(c)(2)(B) on the date of distribution, but that are not actively traded, would not qualify for this exception. Commentators suggested that the final regulations should not include this requirement or should include a more narrowly drafted provision. In response to these comments, the final regulations provide that a security that falls within the definition of marketable security may qualify for the exceptions under § 1.731-2(d) of the final regulations even if the security is not actively traded on the date of distribution. An anti-stuffing rule has been added to address the concern to which the actively-traded requirement of the proposed regulations was directed.

Several comments also suggested that § 1.731-2(d)(2) of the proposed regulations should allow a de minimis amount of cash and marketable securities to be

transferred in a nonrecognition transaction. The final regulations provide that if the value of money and marketable securities transferred in a nonrecognition transaction is less than 20 percent of the total amount of all property transferred in exchange for the distributed security, the entire value of the distributed security will qualify for the nonrecognition transaction exception under § 1.731-2(d)(1)(ii) of the final regulations.

Several commentators also suggested that the five-year rules of § 1.731-2(d)(2) and (3) of the proposed regulations be eliminated. Section 1.731-2(d)(2) of the proposed regulations provided that a marketable security that was acquired in a nonrecognition transaction in exchange for other property and distributed within five years by the partnership would not be subject to section 731(c). Section 1.731-2(d)(3) of the proposed regulations provided that a marketable security that was acquired by the partnership before it became actively traded would also not be subject to section 731(c) if it was distributed by the partnership within five years of becoming actively traded. One commentator, for example, argued that a security is no less a substitute for the underlying assets in a nonrecognition transaction after five years than before five years. These five-year rules were included in the proposed regulations because of administrative concerns. For example, it may be difficult, after the passage of many years, for taxpayers or the IRS to determine the circumstances in which a partnership acquired a particular security. Moreover, it is not clear whether certain exceptions should apply to a distribution of securities if those securities were acquired by a partnership many years ago and are now distributed to a partner who was not a partner at the time the securities were acquired. These administrative concerns remain valid, and a five year time limitation provides a reasonable and simple solution to such problems. Therefore, the final regulations retain both five-year rules.

One comment requested clarification regarding whether a section 708(b)(1)-(B) termination affects a partnership’s qualification for the exceptions under § 1.731-2(d) and (e) of the regulations. Another commentator suggested that the regulations be modified to provide that marketable securities will not be treated as money when there is a deemed distribution of marketable securities by the terminating partnership as the result

of a section 708(b)(1)(B) termination. In response to these comments, the final regulations provide that a section 708(b)(1)(B) termination does not have any effect on a partnership’s qualification for the exceptions under section 731(c). In addition, a deemed distribution occurring as a result of a section 708(b)(1)(B) termination will not be subject to section 731(c).

Several comments suggested that the 10-percent test in the investment partnership look-through rule under § 1.731-2(e)(4) of the proposed regulations should be modified or eliminated. A partnership can qualify for the investment partnership exception only if it has never been engaged in a trade or business and substantially all of its assets are investment assets. Under the proposed regulations, a partnership is treated as engaged in a trade or business engaged in by, or as holding a proportionate share of the assets of, a lower-tier partnership in which the partnership holds a partnership interest unless the upper-tier partnership does not participate in the management of the lower-tier partnership and the interest held by the upper-tier partnership is less than 10 percent of the total profits and capital interests in the lower-tier partnership. According to the comments, the requirement that the upper-tier partnership not participate in the management of the lower-tier partnership should be sufficient to ensure passive ownership of the interest in the lower-tier partnership. The commentators further argued that ownership of more than 10 percent of the capital and profits interest in a lower-tier partnership may still be consistent with passive ownership. After consideration of these comments, the final regulations modify the rule in the proposed regulations to increase the threshold ownership percentage amount from 10 to 20 percent.

In response to a comment, the final regulations clarify that an interest in a lower-tier partnership that qualifies for the exception to the investment partnership “look-through” rule is treated as eligible property for purposes of determining whether the partner who contributed the lower-tier partnership interest is an eligible partner of the upper-tier investment partnership.

One commentator recommended that the regulations include an example that illustrates the section 732(a)(2) ordering rules for distributions that include money, marketable securities and other property, and to clarify whether market-

able securities are treated as money for purposes of section 732(a)(2). Because the statute and the regulations provide that marketable securities are treated as money only for purposes of sections 731(a)(1) and 737, no additional examples are necessary.

One comment suggested that the effective date of the regulations should be the same as the effective date of section 731(c) because the regulations contain guidance for the various exceptions provided for by the Internal Revenue Code. In response to this comment, the final regulations provide that, for the period between the effective date of the statutory provision and the effective date of these regulations, taxpayers may apply the rules contained in these regulations. Another comment suggested that the final regulations should make clear that the rules in the investment partnership exception apply with respect to all property contributed to, or held by, a partnership at any time (including any period prior to the enactment of section 731(c)). The IRS and Treasury believe that this is sufficiently clear from the statutory language, and an explicit statement to this effect in these regulations is not necessary and may be confusing.

One comment requested that the regulations provide several examples illustrating abusive transactions intended to be covered by the anti-abuse rules of § 1.731-2(h), and that these rules be coordinated with the general anti-abuse rules of § 1.701-2. After consideration of this comment, it has been determined that the text of the regulations adequately describes several situations that would be considered abusive under these rules, and that additional examples are unnecessary.

In response to several comments, the final regulations clarify that the 90 percent test of § 1.731-2(c)(2)(i) and the 20 percent test of § 1.731-2(c)(2)(ii) are determined using the gross value of the entity's assets, disregarding any debt that may encumber or otherwise be allocable to those assets, other than debt that is incurred to acquire property with a principal purpose of avoiding or reducing the effect of section 731(c).

Finally, the regulations clarify the interaction of the limitation on gain rule in section 731(c)(3)(B) and the various exceptions listed in paragraph (d). The regulations provide that any gain or loss on a distributed security that qualifies for an exception is not taken into account in determining the distributee partner's limitation on gain.

III. Effective dates

In general, section 731(c) applies to distributions made after December 8, 1994. These regulations are effective for distributions made on or after December 26, 1996. However, taxpayers may apply the rules of this section to distributions made after December 8, 1994, and before December 26, 1996.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the notice of proposed rulemaking preceding the regulations was issued prior to March 29, 1996, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are Terri A. Belanger and William M. Kostak, Office of Assistant Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805. * * *

Section 1.731-2 also issued under 26 U.S.C. 731(c). * * *

Par. 2. Section 1.731-2 is added to read as follows:

§ 1.731-2 Partnership distributions of marketable securities.

(a) *Marketable securities treated as money.* Except as otherwise provided in section 731(c) and this section, for purposes of sections 731(a)(1) and 737, the term *money* includes marketable securi-

ties and such securities are taken into account at their fair market value as of the date of the distribution.

(b) *Reduction of amount treated as money—(1) Aggregation of securities.* For purposes of section 731(c)(3)(B) and this paragraph (b), all marketable securities held by a partnership are treated as marketable securities of the same class and issuer as the distributed security.

(2) *Amount of reduction.* The amount of the distribution of marketable securities that is treated as a distribution of money under section 731(c) and paragraph (a) of this section is reduced (but not below zero) by the excess, if any, of—

(i) The distributee partner's distributive share of the net gain, if any, which would be recognized if all the marketable securities held by the partnership were sold (immediately before the transaction to which the distribution relates) by the partnership for fair market value; over

(ii) The distributee partner's distributive share of the net gain, if any, which is attributable to the marketable securities held by the partnership immediately after the transaction, determined by using the same fair market value as used under paragraph (b)(2)(i) of this section.

(3) *Distributee partner's share of net gain.* For purposes of section 731(c)(3)(B) and paragraph (b)(2) of this section, a partner's distributive share of net gain is determined—

(i) By taking into account any basis adjustments under section 743(b) with respect to that partner;

(ii) Without taking into account any special allocations adopted with a principal purpose of avoiding the effect of section 731(c) and this section; and

(iii) Without taking into account any gain or loss attributable to a distributed security to which paragraph (d)(1) of this section applies.

(c) *Marketable securities—(1) In general.* For purposes of section 731(c) and this section, the term *marketable securities* is defined in section 731(c)(2).

(2) *Actively traded.* For purposes of section 731(c) and this section, a financial instrument is actively traded (and thus is a marketable security) if it is of a type that is, as of the date of distribution, actively traded within the meaning of section 1092(d)(1). Thus, for example, if XYZ common stock is listed on a national securities exchange, particular shares of XYZ common stock that are distributed by a partnership are market-

able securities even if those particular shares cannot be resold by the distributee partner for a designated period of time.

(3) *Interests in an entity*—
(i) *Substantially all*. For purposes of section 731(c)(2)(B)(v) and this section, substantially all of the assets of an entity consist (directly or indirectly) of marketable securities, money, or both only if 90 percent or more of the assets of the entity (by value) at the time of the distribution of an interest in the entity consist (directly or indirectly) of marketable securities, money, or both.

(ii) *Less than substantially all*. For purposes of section 731(c)(2)(B)(vi) and this section, an interest in an entity is a marketable security to the extent that the value of the interest is attributable (directly or indirectly) to marketable securities, money, or both, if less than 90 percent but 20 percent or more of the assets of the entity (by value) at the time of the distribution of an interest in the entity consist (directly or indirectly) of marketable securities, money, or both.

(4) *Value of assets*. For purposes of section 731(c) and this section, the value of the assets of an entity is determined without regard to any debt that may encumber or otherwise be allocable to those assets, other than debt that is incurred to acquire an asset with a principal purpose of avoiding or reducing the effect of section 731(c) and this section.

(d) *Exceptions*—(1) *In general*. Except as otherwise provided in paragraph (d)(2) of this section, section 731(c) and this section do not apply to the distribution of a marketable security if—

(i) The security was contributed to the partnership by the distributee partner;

(ii) The security was acquired by the partnership in a nonrecognition transaction, and the following conditions are satisfied—

(A) The value of any marketable securities and money exchanged by the partnership in the nonrecognition transaction is less than 20 percent of the value of all the assets exchanged by the partnership in the nonrecognition transaction; and

(B) The partnership distributed the security within five years of either the date the security was acquired by the partnership or, if later, the date the security became marketable; or

(iii) The security was not a marketable security on the date acquired by the partnership, and the following conditions are satisfied—

(A) The entity that issued the security had no outstanding marketable securities at the time the security was acquired by the partnership;

(B) The security was held by the partnership for at least six months before the date the security became marketable; and

(C) The partnership distributed the security within five years of the date the security became marketable.

(2) *Anti-stuffing rule*. Paragraph (d)(1) of this section does not apply to the extent that 20 percent or more of the value of the distributed security is attributable to marketable securities or money contributed (directly or indirectly) by the partnership to the entity to which the distributed security relates after the security was acquired by the partnership (other than marketable securities contributed by the partnership that were originally contributed to the partnership by the distributee partner). For purposes of this paragraph (d)(2), money contributed by the distributing partnership does not include any money deemed contributed by the partnership as a result of section 752.

(3) *Successor security*. Section 731(c) and this section apply to the distribution of a marketable security acquired by the partnership in a nonrecognition transaction in exchange for a security the distribution of which immediately prior to the exchange would have been excepted under this paragraph (d) only to the extent that section 731(c) and this section otherwise would have applied to the exchanged security.

(e) *Investment partnerships*—(1) *In general*. Section 731(c) and this section do not apply to the distribution of marketable securities by an investment partnership (as defined in section 731(c)(3)(C)(i)) to an eligible partner (as defined in section 731(c)(3)(C)(iii)).

(2) *Eligible partner*—(i) *Contributed services*. For purposes of section 731(c)(3)(C)(iii) and this section, a partner is not treated as a partner other than an eligible partner solely because the partner contributed services to the partnership.

(ii) *Contributed partnership interests*. For purposes of determining whether a partner is an eligible partner under section 731(c)(3)(C), if the partner has contributed to the investment partnership an interest in another partnership that

meets the requirements of paragraph (e)(4)(i) of this section after the contribution, the contributed interest is treated as property specified in section 731(c)(3)(C)(i).

(3) *Trade or business activities*. For purposes of section 731(c)(3)(C) and this section, a partnership is not treated as engaged in a trade or business by reason of—

(i) Any activity undertaken as an investor, trader, or dealer in any asset described in section 731(c)(3)(C)(i), including the receipt of commitment fees, break-up fees, guarantee fees, director's fees, or similar fees that are customary in and incidental to any activities of the partnership as an investor, trader, or dealer in such assets;

(ii) Reasonable and customary management services (including the receipt of reasonable and customary fees in exchange for such management services) provided to an investment partnership (within the meaning of section 731(c)(3)(C)(i)) in which the partnership holds a partnership interest; or

(iii) Reasonable and customary services provided by the partnership in assisting the formation, capitalization, expansion, or offering of interests in a corporation (or other entity) in which the partnership holds or acquires a significant equity interest (including the provision of advice or consulting services, bridge loans, guarantees of obligations, or service on a company's board of directors), provided that the anticipated receipt of compensation for the services, if any, does not represent a significant purpose for the partnership's investment in the entity and is incidental to the investment in the entity.

(4) *Partnership tiers*. For purposes of section 731(c)(3)(C)(iv) and this section, a partnership (upper-tier partnership) is not treated as engaged in a trade or business engaged in by, or as holding (instead of a partnership interest) a proportionate share of the assets of, a partnership (lower-tier partnership) in which the partnership holds a partnership interest if—

(i) The upper-tier partnership does not actively and substantially participate in the management of the lower-tier partnership; and

(ii) The interest held by the upper-tier partnership is less than 20 percent of the total profits and capital interests in the lower-tier partnership.

(f) *Basis rules*—(1) *Partner's basis*—
(i) *Partner's basis in distributed securities*. The distributee partner's basis in

distributed marketable securities with respect to which gain is recognized by reason of section 731(c) and this section is the basis of the security determined under section 732, increased by the amount of such gain. Any increase in the basis of the marketable securities attributable to gain recognized by reason of section 731(c) and this section is allocated to marketable securities in proportion to their respective amounts of unrealized appreciation in the hands of the partner before such increase.

(ii) *Partner's basis in partnership interest.* The basis of the distributee partner's interest in the partnership is determined under section 733 as if no gain were recognized by the partner on the distribution by reason of section 731(c) and this section.

(2) *Basis of partnership property.* No adjustment is made to the basis of partnership property under section 734 as a result of any gain recognized by a partner, or any step-up in the basis in the distributed marketable securities in the hands of the distributee partner, by reason of section 731(c) and this section.

(g) *Coordination with other sections—(1) Sections 704(c)(1)(B) and 737—(i) In general.* If a distribution results in the application of sections 731(c) and one or both of sections 704(c)(1)(B) and 737, the effect of the distribution is determined by applying section 704(c)(1)(B) first, section 731(c) second, and finally section 737.

(ii) *Section 704(c)(1)(B).* The basis of the distributee partner's interest in the partnership for purposes of determining the amount of gain, if any, recognized by reason of section 731(c) (and for determining the basis of the marketable securities in the hands of the distributee partner) includes the increase or decrease, if any, in the partner's basis that occurs under section 704(c)(1)(B)(iii) as a result of a distribution to another partner of property contributed by the distributee partner in a distribution that is part of the same distribution as the marketable securities.

(iii) *Section 737—(A) Marketable securities as other property.* A distribution of marketable securities is treated as a distribution of property other than money for purposes of section 737 to the extent that the marketable securities are not treated as money under section 731(c). In addition, marketable securities contributed to the partnership are treated as property other than money in deter-

mining the contributing partner's net precontribution gain under section 737(b).

(B) *Basis increase under section 737.* The basis of the distributee partner's interest in the partnership for purposes of determining the amount of gain, if any, recognized by reason of section 731(c) (and for determining the basis of the marketable securities in the hands of the distributee partner) does not include the increase, if any, in the partner's basis that occurs under section 737(c)(1) as a result of a distribution of property to the distributee partner in a distribution that is part of the same distribution as the marketable securities.

(2) *Section 708(b)(1)(B).* If a partnership termination occurs under section 708(b)(1)(B), the successor partnership will be treated as if there had been no termination for purposes of section 731(c) and this section. Accordingly, a section 708(b)(1)(B) termination will not affect whether a partnership qualifies for any of the exceptions in paragraphs (d) and (e) of this section. In addition, a deemed distribution that may occur as a result of a section 708(b)(1)(B) termination will not be subject to section 731(c) and this section.

(h) *Anti-abuse rule.* The provisions of section 731(c) and this section must be applied in a manner consistent with the purpose of section 731(c) and the substance of the transaction. Accordingly, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 731(c) and this section, the Commissioner can recast the transaction for Federal tax purposes as appropriate to achieve tax results that are consistent with the purpose of section 731(c) and this section. Whether a tax result is inconsistent with the purpose of section 731(c) and this section must be determined based on all the facts and circumstances. For example, under the provisions of this paragraph (h)—

(1) A change in partnership allocations or distribution rights with respect to marketable securities may be treated as a distribution of the marketable securities subject to section 731(c) if the change in allocations or distribution rights is, in substance, a distribution of the securities;

(2) A distribution of substantially all of the assets of the partnership other than marketable securities and money to some partners may also be treated as a distribution of marketable securities to the remaining partners if the distribution

of the other property and the withdrawal of the other partners is, in substance, equivalent to a distribution of the securities to the remaining partners; and

(3) The distribution of multiple properties to one or more partners at different times may also be treated as part of a single distribution if the distributions are part of a single plan of distribution.

(i) [Reserved]

(j) *Examples.* The following examples illustrate the rules of this section. Unless otherwise specified, all securities held by a partnership are marketable securities within the meaning of section 731(c); the partnership holds no marketable securities other than the securities described in the example; all distributions by the partnership are subject to section 731(a) and are not subject to sections 704(c)(1)(B), 707(a)(2)(B), 751(b), or 737; and no securities are eligible for an exception to section 731(c). The examples read as follows:

Example 1. Recognition of gain. (i) *A* and *B* form partnership *AB* as equal partners. *A* contributes property with a fair market value of \$1,000 and an adjusted tax basis of \$250. *B* contributes \$1,000 cash. *AB* subsequently purchases Security *X* for \$500 and immediately distributes the security to *A* in a current distribution. The basis in *A*'s interest in the partnership at the time of distribution is \$250.

(ii) The distribution of Security *X* is treated as a distribution of money in an amount equal to the fair market value of Security *X* on the date of distribution (\$500). (The amount of the distribution that is treated as money is not reduced under section 731(c)(3)(B) and paragraph (b) of this section because, if Security *X* had been sold immediately before the distribution, there would have been no gain recognized by *AB* and *A*'s distributive share of the gain would therefore have been zero.) As a result, *A* recognizes \$250 of gain under section 731(a)(1) on the distribution (\$500 distribution of money less \$250 adjusted tax basis in *A*'s partnership interest).

Example 2. Reduction in amount treated as money—in general. (i) *A* and *B* form partnership *AB* as equal partners. *AB* subsequently distributes Security *X* to *A* in a current distribution. Immediately before the distribution, *AB* held securities with the following fair market values, adjusted tax bases, and unrecognized gain or loss:

	Value	Basis	Gain (Loss)
Security <i>X</i>	100	70	30
Security <i>Y</i>	100	80	20
Security <i>Z</i>	100	110	(10)

(ii) If *AB* had sold the securities for fair market value immediately before the distribution to *A*, the partnership would have recognized \$40 of net gain (\$30 gain on Security *X* plus \$20 gain on Security *Y* minus \$10 loss on Security *Z*). *A*'s distributive share of this gain would have been \$20 (one-half of \$40 net gain). If *AB* had sold the remaining securities immediately after the distribution of Security *X* to *A*, the partnership would have \$10 of net gain (\$20 of gain on Security *Y* minus \$10 loss on Security *Z*). *A*'s distributive share of this gain would have been \$5 (one-half of \$10 net gain). As a result, the distribution resulted in a

decrease of \$15 in A's distributive share of the net gain in AB's securities (\$20 net gain before distribution minus \$5 net gain after distribution).

(iii) Under paragraph (b) of this section, the amount of the distribution of Security X that is treated as a distribution of money is reduced by \$15. The distribution of Security X is therefore treated as a distribution of \$85 of money to A (\$100 fair market value of Security X minus \$15 reduction).

Example 3. Reduction in amount treated as money—carried interest. (i) A and B form partnership AB. A contributes \$1,000 and provides substantial services to the partnership in exchange for a 60 percent interest in partnership profits. B contributes \$1,000 in exchange for a 40 percent interest in partnership profits. AB subsequently distributes Security X to A in a current distribution. Immediately before the distribution, AB held securities with the following fair market values, adjusted tax bases, and unrecognized gain:

	Value	Basis	Gain
Security X	100	80	20
Security Y	100	90	10

(ii) If AB had sold the securities for fair market value immediately before the distribution to A, the partnership would have recognized \$30 of net gain (\$20 gain on Security X plus \$10 gain on Security Y). A's distributive share of this gain would have been \$18 (60 percent of \$30 net gain). If AB had sold the remaining securities immediately after the distribution of Security X to A, the partnership would have \$10 of net gain (\$10 gain on Security Y). A's distributive share of this gain would have been \$6 (60 percent of \$10 net gain). As a result, the distribution resulted in a decrease of \$12 in A's distributive share of the net gain in AB's securities (\$18 net gain before distribution minus \$6 net gain after distribution).

(iii) Under paragraph (b) of this section, the amount of the distribution of Security X that is treated as a distribution of money is reduced by \$12. The distribution of Security X is therefore treated as a distribution of \$88 of money to A (\$100 fair market value of Security X minus \$12 reduction).

Example 4. Reduction in amount treated as money—change in partnership allocations. (i) A is admitted to partnership ABC as a partner with a 1 percent interest in partnership profits. At the time of A's admission, ABC held no securities. ABC subsequently acquires Security X. A's interest in partnership profits is subsequently increased to 2 percent for securities acquired after the increase. A retains a 1 percent interest in all securities acquired before the increase. ABC then acquires Securities Y and Z and later distributes Security X to A in a current distribution. Immediately before the distribution, the securities held by ABC had the following fair market values, adjusted tax bases, and unrecognized gain or loss:

	Value	Basis	Gain (Loss)
Security X	1,000	500	500
Security Y	1,000	800	200
Security Z	1,000	1,100	(100)

(ii) If ABC had sold the securities for fair market value immediately before the distribution to A, the partnership would have recognized \$600 of net gain (\$500 gain on Security X plus \$200 gain on Security Y minus \$100 loss on Security Z). A's distributive share of this gain would have been \$7 (1 percent of \$500 gain on Security X plus 2 percent of \$200 gain on Security Y minus 2 percent of \$100 loss on Security Z).

(iii) If ABC had sold the remaining securities immediately after the distribution of Security X to A, the partnership would have \$100 of net gain (\$200 gain on Security Y minus \$100 loss on Security Z). A's distributive share of this gain would have been \$2 (2 percent of \$200 gain on Security Y minus 2 percent of \$100 loss on Security Z). As a result, the distribution resulted in a decrease of \$5 in A's distributive share of the net gain in ABC's securities (\$7 net gain before distribution minus \$2 net gain after distribution).

(iv) Under paragraph (b) of this section, the amount of the distribution of Security X that is treated as a distribution of money is reduced by \$5. The distribution of Security X is therefore treated as a distribution of \$95 of money to A (\$100 fair market value of Security X minus \$5 reduction).

Example 5. Basis consequences—distribution of marketable security. (i) A and B form partnership AB as equal partners. A contributes nondepreciable real property with a fair market value and adjusted tax basis of \$100.

(ii) AB subsequently distributes Security X with a fair market value of \$120 and an adjusted tax basis of \$90 to A in a current distribution. At the time of distribution, the basis in A's interest in the partnership is \$100. The amount of the distribution that is treated as money is reduced under section 731(c)(3)(B) and paragraph (b)(2) of this section by \$15 (one-half of \$30 net gain in Security X). As a result, A recognizes \$5 of gain under section 731(a) on the distribution (excess of \$105 distribution of money over \$100 adjusted tax basis in A's partnership interest).

(iii) A's adjusted tax basis in Security X is \$95 (\$90 adjusted basis of Security X determined under section 732(a)(1) plus \$5 of gain recognized by A by reason of section 731(c)). The basis in A's interest in the partnership is \$10 as determined under section 733 (\$100 pre-distribution basis minus \$90 basis allocated to Security X under section 732).

Example 6. Basis consequences—distribution of marketable security and other property. (i) A and B form partnership AB as equal partners. A contributes nondepreciable real property, with a fair market value of \$100 and an adjusted tax basis of \$10.

(ii) AB subsequently distributes Security X with a fair market value and adjusted tax basis of \$40 to A in a current distribution and, as part of the same distribution, AB distributes Property Z to A with an adjusted tax basis and fair market value of \$40. At the time of distribution, the basis in A's interest in the partnership is \$10. A recognizes \$30 of gain under section 731(a) on the distribution (excess of \$40 distribution of money over \$10 adjusted tax basis in A's partnership interest).

(iii) A's adjusted tax basis in Security X is \$35 (\$5 adjusted basis determined under section 732(a)(2) plus \$30 of gain recognized by A by reason of section 731(c)). A's basis in Property Z is \$5, as determined under section 732(a)(2). The basis in A's interest in the partnership is \$0 as determined under section 733 (\$10 pre-distribution basis minus \$10 basis allocated between Security X and Property Z under section 732).

(iv) AB's adjusted tax basis in the remaining partnership assets is unchanged unless the partnership has a section 754 election in effect. If AB made such an election, the aggregate basis of AB's assets would be increased by \$70 (the difference between the \$80 combined basis of Security X and Property Z in the hands of the partnership before the distribution and the \$10 combined basis of the distributed property in the hands of A under section 732 after the distribution). Under section

731(c)(5), no adjustment is made to partnership property under section 734 as a result of any gain recognized by A by reason of section 731(c) or as a result of any step-up in basis in the distributed marketable securities in the hands of A by reason of section 731(c).

Example 7. Coordination with section 737. (i) A and B form partnership AB. A contributes Property A, nondepreciable real property with a fair market value of \$200 and an adjusted basis of \$100 in exchange for a 25 percent interest in partnership capital and profits. AB owns marketable Security X.

(ii) Within five years of the contribution of Property A, AB subsequently distributes Security X, with a fair market value of \$120 and an adjusted tax basis of \$100, to A in a current distribution that is subject to section 737. As part of the same distribution, AB distributes Property Y to A with a fair market value of \$20 and an adjusted tax basis of \$0. At the time of distribution, there has been no change in the fair market value of Property A or the adjusted tax basis in A's interest in the partnership.

(iii) If AB had sold Security X for fair market value immediately before the distribution to A, the partnership would have recognized \$20 of gain. A's distributive share of this gain would have been \$5 (25 percent of \$20 gain). Because AB has no other marketable securities, A's distributive share of gain in partnership securities after the distribution would have been \$0. As a result, the distribution resulted in a decrease of \$5 in A's share of the net gain in AB's securities (\$5 net gain before distribution minus \$0 net gain after distribution). Under paragraph (b)(2) of this section, the amount of the distribution of Security X that is treated as a distribution of money is reduced by \$5. The distribution of Security X is therefore treated as a distribution of \$115 of money to A (\$120 fair market value of Security X minus \$5 reduction). The portion of the distribution of the marketable security that is not treated as a distribution of money (\$5) is treated as other property for purposes of section 737.

(iv) A recognizes total gain of \$40 on the distribution. A recognizes \$15 of gain under section 731(a)(1) on the distribution of the portion of Security X treated as money (\$115 distribution of money less \$100 adjusted tax basis in A's partnership interest). A recognizes \$25 of gain under section 737 on the distribution of Property Y and the portion of Security X that is not treated as money. A's section 737 gain is equal to the lesser of (i) A's pre-contribution gain (\$100) or (ii) the excess of the fair market value of property received (\$20 fair market value of Property Y plus \$5 portion of Security X not treated as money) over the adjusted basis in A's interest in the partnership immediately before the distribution (\$100) reduced (but not below zero) by the amount of money received in the distribution (\$115).

(v) A's adjusted tax basis in Security X is \$115 (\$100 basis of Security X determined under section 732(a) plus \$15 of gain recognized by reason of section 731(c)). A's adjusted tax basis in Property Y is \$0 under section 732(a). The basis in A's interest in the partnership is \$25 (\$100 basis before distribution minus \$100 basis allocated to Security X under section 732(a) plus \$25 gain recognized under section 737).

(k) *Effective date.* This section applies to distributions made on or after December 26, 1996. However, taxpayers may apply the rules of this section to

distributions made after December 8, 1994, and before December 26, 1996.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved November 27, 1996.

Donald C. Lubick,
*Assistant Secretary of the
Treasury (Tax Policy).*

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