

Notice of Proposed Rulemaking and Notice of Public Hearing

Distribution of Marketable Securities by a Partnership

PS-2-95

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the treatment of a distribution of marketable securities by a partnership under section 731(c) of the Internal Revenue Code of 1986, as amended (Code). These proposed regulations provide taxpayers with guidance needed to comply with certain changes made by the Uruguay Round Agreements Act of 1994. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments and requests to speak (with outlines of oral comments) at a public hearing scheduled for 10 a.m. on Wednesday, April 3, 1996 must be received by Wednesday, March 13, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (PS-2-95), Room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (PS-2-95), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. The public hearing will be held in the IRS Auditorium.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Terri A. Belanger or William M. Kostak, (202) 622-3080; concerning submissions and the hearing, Christina Vasquez, (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Introduction

This document proposes to add §1.731-2 to the Income Tax Regula-

tions (26 CFR part 1) under section 731(c) of the Code. Section 731(c) was amended by section 741(a) of the Uruguay Round Agreements Act of 1994 (Public Law 103-465).

Background

Section 731(a)(1) of the Code provides that a partner must recognize gain on a distribution from a partnership to the extent that any money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution. Section 737 provides that a partner must recognize gain on a distribution of property other than money in an amount equal to the lesser of (i) the partner's net precontribution gain or (ii) the excess of the fair market value of the distributed property over the partner's basis in the partnership interest.

Section 731(c) provides that the term *money* includes marketable securities for purposes of section 731(a)(1) and section 737. As discussed in the legislative history accompanying section 731(c), treating marketable securities as money for this purpose is appropriate because marketable securities are economically equivalent to money. Section 731(c) affects only the tax consequences to the distributee partner; section 731(c) does not require the partnership or any partner other than the distributee partner to recognize gain on a distribution of marketable securities.

Explanation of Provisions

Marketable securities treated as money

Distributions of marketable securities are treated as distributions of money under section 731(c) only for purposes of sections 731(a)(1) and 737. For example, a distribution of marketable securities is not treated as a distribution of money to the extent it is subject to section 707 or section 751(b) because the distribution is not subject to section 731(a)(1) or section 737. In addition, marketable securities are not treated as money for purposes of section 731(a)(2), so that a partner does not recognize a loss on a distribution of marketable

securities. Finally, marketable securities contributed by a partner are treated as property other than money for purposes of determining the partner's net pre-contribution gain under section 737(b).

Reduction of amount treated as money

Under section 731(c)(3)(B), the amount of marketable securities that is treated as money is reduced by the excess of (i) the partner's share of the net gain of the partnership's securities of the same class and issuer as the distributed securities immediately before the distribution over (ii) the partner's share of such net gain immediately after the distribution. This provision allows a partner to withdraw the partner's share of appreciation in the partnership's marketable securities without recognizing gain on the distribution. As a result, section 731(c) generally applies only when a partner receives a distribution of marketable securities in exchange for the partner's share of appreciated assets other than marketable securities.

Under the authority of section 731(c)(3)(B), the proposed regulations provide that all marketable securities held by a partnership are treated as marketable securities of the same class and issuer as the distributed securities. Treating all marketable securities as a single asset for this purpose is consistent with the basic rationale of section 731(c) that marketable securities are the economic equivalent of money. As a result, the amount of the distribution that is not treated as money will depend on the partner's share of the net appreciation in all partnership securities, not on the partner's share of the appreciation in the type of securities distributed.

Definition of marketable securities

In general, the term *marketable securities* includes any financial instruments—such as stocks, options, and derivatives—that are actively traded within the meaning of section 1092(d)(1). In addition, section 731(c)(2)(B)(v) provides that an interest in an entity is a marketable security if substantially all of the assets of the entity consist of marketable securities

or money. The proposed regulations provide that substantially all of the assets of an entity consist of marketable securities or money only if 90 percent or more of the assets of the entity at the time of the distribution consist of such assets.

Section 731(c)(2)(B)(vi) provides that, to the extent provided in regulations, an interest in an entity not described in section 731(c)(2)(B)(v) is a marketable security to the extent that the value of such interest is attributable to marketable securities or money. The proposed regulations provide that an interest in an entity is a marketable security to the extent that the value of the interest is attributable to marketable securities or money that constitute less than 90 percent but 20 percent or more of the assets of the entity. The 20 percent threshold means that an interest in an entity holding only a small amount of marketable securities will not be treated as a marketable security.

The proposed regulations also provide that a marketable security will continue to be treated as a marketable security, even if the partnership or its partners are restricted by agreement or otherwise from selling or exchanging the security. This provision is intended to prevent a partnership from avoiding section 731(c) by temporarily restricting the transferability of the distributed security.

Exceptions

Consistent with the provisions of section 731(c)(3)(A), the proposed regulations provide three exceptions to section 731(c). First, the proposed regulations provide that if the marketable security was contributed to the partnership by the distributee partner, section 731(c) does not apply to the distribution of that security.

Second, the proposed regulations provide that section 731(c) does not apply to the distribution of a marketable security to the extent that the security was acquired by the partnership in a nonrecognition transaction in exchange for property other than marketable securities or cash and (i) the security is actively traded as of the date of distribution and (ii) the security is distributed by the partnership within five years of either the date the security was acquired by the partnership or, if later, the date the security became actively traded. For example, if a

partnership contributed substantially all of its assets to a corporation in a transaction described in section 351 and the stock of the corporation became marketable, the distribution of the stock by the partnership within five years would not be subject to section 731(c). This exception recognizes that the marketable security in these situations is simply a substitute for the underlying assets exchanged in the nonrecognition transaction.

The proposed regulations also provide that section 731(c) does not apply to the distribution of a marketable security if (i) the security was not actively traded on the date acquired by the partnership and the entity to which the security relates had no outstanding actively traded securities at the time the security was acquired by the partnership; (ii) the security is actively traded as of the date of distribution; and (iii) the security was held by the partnership for at least six months before it became actively traded and the security was distributed by the partnership within five years of the date on which the security became actively traded.

In addition, the proposed regulations provide a successor security rule that applies to these exceptions. This rule provides that the exceptions continue to apply to a security acquired in a nonrecognition transaction in exchange for a security that was already subject to an exception.

Investment partnerships

Section 731(c) does not apply to the distribution of marketable securities by an investment partnership to an eligible partner. An investment partnership is defined as a partnership that has never been engaged in a trade or business and substantially all of the assets of which consist of the investment assets described in section 731(c)(3)(C)(i). The proposed regulations provide that a partner can qualify as an eligible partner even if the partner contributed services to the partnership. In addition, the proposed regulations provide that a partnership will not be treated as engaged in a trade or business if the partnership provides reasonable and customary management services to a lower-tier investment partnership. This exception allows an upper-tier investment partnership to manage the investments and other activities of a lower-

tier investment partnership without disqualifying the upper-tier partnership as an investment partnership. The exception does not extend to management services provided to lower-tier partnerships other than investment partnerships because, as discussed below, the tiering rules of section 731(c)(3)-(C)(iv) treat the upper-tier management partnership as engaged in the trade or business of the lower-tier partnership, thereby preventing the upper-tier partnership from qualifying as an investment partnership.

The proposed regulations also provide that a partnership will not be treated as engaged in a trade or business if the partnership provides reasonable and customary services in assisting the formation, capitalization, expansion, or offering of interests in an entity in which the partnership holds a significant equity interest, provided that the anticipated receipt of compensation for the services does not represent a significant purpose for the partnership's investment in the entity and is incidental to the investment in the entity.

Section 731(c)(3)(C)(iv) provides that, except as otherwise provided in regulations, a partnership is treated as engaged in any trade or business engaged in by (and as holding the assets of) any partnership in which the partnership holds an interest. The proposed regulations provide that this look-through rule does not apply if 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.

Coordination with other sections

The proposed regulations provide rules for coordinating section 731(c) with section 704(c)(1)(B) and section 737. This coordination is necessary because a distribution of marketable securities could occur as part of a larger distribution in which property contributed by the distributee partner is distributed to another partner (section 704(c)(1)(B)) or the distributee partner receives property in addition to marketable securities (section 737).

Under the proposed regulations, the basis increase in the partner's interest in the partnership as a result of any gain recognized by the partner under

section 704(c)(1)(B) is taken into account in determining the distributee partner's gain under section 731(c) and the partner's basis in the distributed securities. Taking the stepped-up basis into account for purposes of section 731 reflects the fact that the general effect of section 704(c)(1)(B) is to treat the contributing partner as having contributed property with a full fair market value basis at the time of contribution. The proposed regulations, however, provide that the basis increase in the partner's interest as a result of any gain recognized by the partner under section 737 is not taken into account for these purposes. The proposed regulations are consistent with section 737, which generally treats a distribution of money as occurring before, and independent of, a distribution of other property.

Anti-abuse rule

The proposed regulations provide that the provisions of section 731(c) and this section must be applied in a manner that is consistent with the purpose of section 731(c) and the substance of the transaction.

Proposed effective date

This section is proposed to apply to distributions of marketable securities by a partnership to a partner on or after Friday, December 29, 1995.

Special Analyses

It has been determined that this notice of proposed rulemaking 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) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consid-

eration will be given to any written comments (a signed original and eight (8) copies) that are timely submitted to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Wednesday, April 3, 1996 at 10:00 a.m. in the Auditorium of the Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by Wednesday, March 13, 1996 and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by Wednesday, March 13, 1996.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

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.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be 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 section 731(a)(1) and 737, the term *money* includes marketable securities 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; and

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

(c) *Marketable securities—(1) 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 marketable securities even if those particular shares cannot be resold by the distributee partner for a designated period of time.

(2) *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.

(d) *Exceptions*—(1) *Previously contributed property*. Section 731(c) and this section do not apply to the distribution of a marketable security if the security was contributed to the partnership by the distributee partner, except to the extent that 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.

(2) *Security acquired in nonrecognition transaction*. Section 731(c) and this section do not apply to the distribution of a marketable security to the extent that—

(i) The security was acquired by the partnership in a nonrecognition transaction in exchange for any property except money or marketable securities (including a security that would have been treated as a marketable security under paragraph (c)(2) of this section if distributed at the time of the exchange);

(ii) The distributed security is actively traded as of the date of distribution; and

(iii) The security is distributed within five years of either the date on which the security was acquired by the partnership or, if later, the date on which the security became actively traded.

(3) *Security not marketable when acquired*. Section 731(c) and this section do not apply to the distribution of a marketable security if—

(i) The security was not actively traded as of the date acquired by the partnership and the entity to which the security relates had no outstanding actively traded securities on that date;

(ii) The security is actively traded as of the date of distribution; and

(iii) The security was held by the partnership for at least six months before the date the security became actively traded and the security was distributed within five years of the date on which the security became actively traded.

(4) *Successor security*. Section 731(c) and this section do not apply to the distribution of a marketable security to the extent that the security was 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).

(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*. 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.

(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 participate in the management of the lower-tier partnership; and

(ii) 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.

(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) 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, 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.

(2) *Section 737—(i) 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 determining the contributing partner's net precontribution gain under section 737(b).

(ii) *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.

(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), 751(b), or 737; and no securities are eligible for an exception to section 731(c).

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 X	100	70	30
Security Y	100	80	20
Security Z	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 <i>X</i>	1,000	500	200
Security <i>Y</i>	1,000	800	200
Security <i>Z</i>	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 of marketable securities made on or after Friday, December 29, 1995.

Margaret Milner Richardson,
Commissioner of
Internal Revenue.

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