to which section 704(c)(1)(B) applies. The basis in the distributed property in that case will be increased or decreased for any gain or loss recognized by the contributing partner under section 704(c)(1)(B) and therefore should not be adjusted for gain recognized under section 737.

The basis increase is allocated to built-in gain property with the same character as the character of the gain recognized by the partner. The amount of the basis increase allocated to property of a particular character is allocated to the property in the order contributed to the partnership, starting with the earliest contributed property. This ordering rule preserves the effect of the five-year rule to the extent possible. Allocating the adjustment to all property of a similar character based on any other rule would reduce the net precontribution gain attributable to later-contributed property before such gain was entirely eliminated on earlier contributed property.

Any increase to the adjusted tax basis of partnership property under the proposed regulations 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.

#### **Proposed Effective Date**

These regulations are proposed to apply to distributions of property by a partnership to a partner on or after January 9, 1995.

### Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also 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, consideration 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 June 19, 1995, at 10 a.m. in the auditorium of the Internal Revenue Building. 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 April 10, 1995 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 May 22, 1995.

A period of 10 minutes will be allotted for 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**

Several persons from the Office of Chief Counsel and the Treasury Department participated in the development of these regulations.

## 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 the following citation:

**Authority:** 26 U.S.C. 7805 \* \* \* Section 1.704–4 also issued under 26 U.S.C. 704(c) \* \* \*

**Par. 2.** Section 1.704–4 is added to read as follows:

# § 1.704–4 Distribution of contributed property.

(a) Determination of gain—(1) In general. A partner that contributes section 704(c) property to a partnership must recognize gain or loss under section 704(c)(1)(B) and this section on the distribution of such property to another partner within five years of its contribution to the partnership, in an amount equal to the gain or loss that would have been allocated to such partner under section 704(c)(1)(A) and

§ 1.704–3 if the distributed property had been sold by the partnership to the distributee partner for its fair market value at the time of the distribution. See § 1.704–3(a)(3)(i) for a definition of section 704(c) property.

(2) Transactions to which section 704(c)(1)(B) applies. Section 704(c)(1)(B) and this section apply only to a distribution that is properly characterized as a distribution to a partner acting in the capacity of a partner within the meaning of section 731 and section 737. Section 704(c)(1)(B) and this section do not apply to a transaction or distribution that is subject to provisions other than section 731(a) or section 737 (for example, a transaction or distribution subject to sections 707(a), 736(a), or 751(b)).

(3) Fair market value of property. The fair market value of the distributed section 704(c) property is the price at which the property would change hands between a willing buyer and a willing seller at the time of the distribution, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. The fair market value that a partnership assigns to distributed section 704(c) property will be regarded as correct, provided that the value is reasonably agreed to among the partners in an arm's-length negotiation and the partners have sufficiently adverse interests.

(4) Determination of five-year period—(i) General rule. The five-year period specified in paragraph (a)(1) of this section begins on and includes the date of contribution.

(ii) Section 708(b)(1)(B) terminations. A termination of the partnership under section 708(b)(1)(B) begins a new fiveyear period for each partner with respect to the built-in gain and built-in loss property that the partner is deemed to recontribute to a new partnership following the termination, but only to the extent that the pre-termination builtin gain or loss, if any, on such property was not already required to be allocated to the original contributor under section 704(c)(1)(A) and § 1.704–3. See § 1.704– 3(a)(3)(ii) for the definitions of built-in gain and built-in loss on section 704(c) property.

(5) Examples. The following examples illustrate the rules of this paragraph (a). 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 704(c)(1)(B), and all partners are unrelated.