year (one-third of the total annual book depreciation of \$3,000). The partnership also has tax depreciation of \$2,000 per year (10 percent of the \$20,000 adjusted tax basis in Property A). This \$2,000 tax depreciation is allocated equally between B and C, the noncontributing partners with respect to Property A.

(iii) At the end of 1997, the book value of Property A is \$21,000 (\$30,000 initial book value less \$9,000 aggregate book depreciation) and its adjusted tax basis is \$14,000 (\$20,000 initial tax basis less \$6,000 aggregate tax depreciation).

(iv) On December 31, 1997, Property B is distributed to A in complete liquidation of A's partnership interest. The adjusted tax basis of A's partnership interest at that time is \$20,000. The amount of the excess distribution is \$10,000, the difference between the fair market value of the distributed Property B (\$30,000) and A's adjusted tax basis in A's partnership interest (\$20,000). A's net precontribution gain is \$7,000, the difference between the book value of Property A (\$21,000) and its adjusted tax basis at the time of the distribution (\$14,000). A recognizes gain of \$7,000 on the distribution, the lesser of the excess distribution and the net precontribution gain.

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

(ii) The partnership purchases Property B, nondepreciable real property with a fair market value of \$9,000, subject to a \$9,000 nonrecourse liability. This nonrecourse liability is allocated equally among the partners under section 752, increasing A's adjusted tax basis in A's partnership interest from \$4,000 to \$7,000.

(iii) On December 31, 1998, A receives \$2,000 cash and Property B, subject to the \$9,000 liability, in partial liquidation of A's interest in the partnership.

(iv) In determining the amount of the excess distribution, the adjusted tax basis of A's partnership interest is adjusted to take into account the distribution of money and the shift in liabilities. A's adjusted tax basis is therefore increased to \$11,000 for this purpose (\$7,000 initial adjusted tax basis, less \$2,000 distribution of money, less \$3,000 (decrease in A's share of the \$9,000 partnership liability), plus \$9,000 (increase in A's individual liabilities)). As a result of this basis adjustment, the adjusted tax basis of A's partnership interest (\$11,000) is greater than the fair market value of the distributed property (\$9,000) and therefore, there is no excess distribution. A recognizes no gain under section 737.

Example 3. Net precontribution gain reduced for gain recognized under section 704(c)(1)(B). (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Properties A1 and A2, nondepreciable real properties each with a fair market value of \$10,000 and an adjusted tax basis of \$6,000. B contributes Property B, nondepreciable real property, with a fair market value and adjusted tax basis of \$20,000. C contributes \$20,000 cash.

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

(iii) A's net precontribution gain before the distribution is \$8,000 (\$20,000 fair market value of Properties A1 and A2 less \$12,000 adjusted tax basis of such properties). A recognizes \$4,000 of gain under section 704(c)(1)(B) and §1.704–4 on the distribution of Property A1 to B (\$10,000 fair market value of Property A1 less \$6,000 adjusted tax basis of Property A1]. This gain is taken into account in determining A's excess distribution and net precontribution gain. As a result, A's net precontribution gain is reduced from \$8,000 to \$4,000, and the adjusted tax basis in A's partnership interest is increased by \$4,000 to \$16,000.

(iv) A recognizes gain of \$4,000 on the receipt of Property B under section 737, an amount equal to the excess distribution of \$4,000 (\$20,000 fair market value of Property B less \$16,000 adjusted tax basis of A's interest in the partnership) and A's remaining net precontribution gain of \$4,000.

Example 4. Character of gain. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes the following nondepreciable property to the partnership:

	Fair mar- ket value	Adjusted tax basis
Property A1	\$30,000	\$20,000
Property A2	30,000	38,000
Property A3	10,000	9,000

(ii) The character of gain or loss on Property A1 and Property A2 is long-term, U.S.-source capital gain or loss. The character of gain on Property A3 is long-term, foreignsource capital gain. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of \$70,000. C contributes \$70,000 cash.

(iii) On December 31, 1998, Property B is distributed to A in complete liquidation of A's interest in the partnership. A recognizes \$3,000 of gain under section 737, an amount equal to the excess distribution of \$3,000 (\$70,000 fair market value of Property B less \$67,000 adjusted tax basis in A's partnership interest) and A's net precontribution gain of \$3,000 (\$70,000 aggregate fair market value of properties contributed by A less \$67,000 aggregate adjusted tax basis of such properties).

(iv) In determining the character of A's gain, all gains and losses on property taken into account in determining A's net precontribution gain are netted according to their character and allocated to A's recognized gain under section 737 based on the relative proportions of the net positive amounts. U.S.-source and foreign-source gains must be netted separately because A would have been required to take such gains into account separately under section 702. As a result, A's net precontribution gain of

\$3,000 consists of \$2,000 of net long-term, U.S.-source capital gain (\$10,000 gain on Property A1 and \$8,000 loss on Property A2) and \$1,000 of net long-term, foreign-source capital gain (\$1,000 gain on Property A3).

(v) The character of A's gain under paragraph (d) of this section is therefore \$2,000 long-term, U.S.-source capital gain (\$3,000 gain recognized under section 737×\$2,000 net long-term, U.S.-source capital gain/\$3,000 total net precontribution gain) and \$1,000 long-term, foreign-source capital gain (\$3,000 gain recognized under section 737×\$1,000 net long-term, foreign-source capital gain/\$3,000 total net precontribution gain).

§1.737–2 Exceptions and special rules.

(a) Section 708(b)(1)(B) terminations. Section 737 and this section do not apply to a deemed distribution of property on a termination of the partnership under section 708(b)(1)(B). See § 1.704-4(c)(3) for a similar rule in the context of section 704(c)(1)(B).

(b) Complete transfer to another partnership. Section 737 and this section do not apply to a transfer by a partnership (transferor partnership) of all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution of the interest in the transferee partnership in complete liquidation of the transferor partnership as part of the same plan or arrangement. In addition, section 737 and this section do not apply to any transaction, such as a partnership merger under section 708(b)(2)(A), that is treated in a similar manner. A subsequent distribution of property by the transferee partnership to the partners of the transferee partnership who were formerly partners of the transferor partnership is subject to section 737 to the same extent that a distribution from the transferor partnership would have been subject to section 737.

(c) Incorporation of a partnership. Section 737 and this section do not apply to an incorporation of a partnership by any method of incorporation (other than a method involving an actual distribution of partnership property to the partners followed by a contribution of that property to a corporation), provided that the partnership is completely liquidated as part of the same plan or arrangement as the incorporation transaction.

(d) Distribution of previously contributed property—(1) General rule. Any portion of the distributed property that consists of property previously contributed by the distributee partner (including property treated as contributed by the partner in connection with a termination of the partnership