

the contributed property for like-kind property in a nontaxable exchange outside of the partnership. This allows the contributing partner to avoid recognition of gain or loss under section 704(c)(1)(B) on the distribution of the contributed property to another partner because the contributing partner is treated as having contributed the like-kind property, not the property that is actually distributed to the other partner.

If the contributing partner, however, had engaged in a like-kind exchange outside of the partnership, the partner's built-in gain or loss in the like-kind property received would have been the same as the property that was surrendered. The rule in the proposed regulations reflects this result by limiting the application of section 704(c)(2) to the extent that the built-in gain or loss in the contributed property is not preserved in the like-kind property distributed to the contributing partner. The IRS and Treasury continue to believe that the regulations properly implement Congress' objective with respect to this provision. Therefore, the regulations are finalized without change.

One commentator also suggested a clarification of the interaction of the like-kind exception and the disguised sale rules of 707(a)(2)(B). The proposed regulations provide that the like-kind exception reduces any gain that would have otherwise been recognized under section 704(c)(1)(B). The proposed regulations also provide that section 704(c)(1)(B) applies only to a distribution to a partner within the meaning of section 731. There is no suggestion in section 704(c)(2) or the proposed regulations that the like-kind exception was intended as an exception to the disguised sale provisions. The final regulations confirm that the disguised sale provisions can apply to a distribution, even if the distribution would otherwise have qualified for the section 704(c)(2) like-kind exception.

#### Anti-Abuse Rule

Commentators made several suggestions for clarifying or modifying the anti-abuse rule in the proposed regulations. In particular, these commentators requested clarification of the relationship between this rule and the general partnership anti-abuse rule in Treas. Reg. section 1.701-2. The general anti-abuse regulation is a rule of general applicability that provides general principles to be applied in interpreting and applying all of the provisions of subchapter K. In certain situations, however, more specific anti-abuse rules are needed to carry out the purpose of a particular provision. The

final regulations therefore adopt the rule in the proposed regulations without modification.

#### B. Section 737

##### Determination of Gain

The final regulations are clarified to provide that section 737 applies only to the extent that a transaction is a distribution under section 731. In accordance with section 737(d)(2), the final regulations also provide that section 737 does not apply to the extent that section 751(b) applies to the distribution.

##### Net Precontribution Gain

The proposed regulations provide that a distributee partner's net precontribution gain is determined without regard to the like-kind exception of section 704(c)(2) in situations in which the contributed property is not actually distributed to another partner. One commentator suggested deleting this provision as superfluous. The final regulations adopt the proposed regulations without change. This provision clarifies that section 737 does not contain a like-kind exception similar to the exception in section 704(c)(2). Section 737 applies even if the property received by the partner is of a like-kind with the contributed property.

##### Character of Gain

One commentator suggested that the proposed regulations fail to clarify whether there are two groups (ordinary and capital) for purposes of determining the character of a partner's net precontribution gain or whether there may be an additional section 1231 group or section 1245 and section 1250 groups. The final regulations adopt the proposed regulations without change.

The proposed regulations provide that character for purposes of a partner's net precontribution gain is determined as if the contributed property were sold to an unrelated third party. As a result, all of the provisions that are relevant in determining the character of gain or loss on a sale are relevant in determining the character of the net precontribution gain. For example, if the sale of property would have resulted in part capital gain and part ordinary income, the character of the net precontribution gain for that property is part ordinary and part capital. The same approach applies in determining the allocation of any adjustment to the partnership's basis in partnership property as a result of gain recognized by the distributee partner. A basis adjustment attributable to gain treated as capital gain under section

1231 would be allocated to the property that entered into the calculation of the amount of section 1231 gain.

One commentator also suggested that the proposed regulations do not clarify whether character is determined at the partnership or the partner level. This determination may be important in situations such as section 1231 where the character of the gain or loss may depend on the partner's particular tax circumstances. The final regulations clarify that the character of the gain or loss is determined at the partnership level for this purpose.

##### Exceptions

One commentator suggested adding an exception for certain divisive transactions in which the contributing partner continued to own an indirect interest in the contributed property. The final regulations add a new exception under which section 737 does not apply to a transfer of contributed property by a transferor partnership to a transferee partnership, followed by a distribution of an interest in the transferee partnership (and no other property) to the contributing partner in complete liquidation of the partner's interest.

This exception is added because the distributee partner has simply converted an interest in the transferor partnership into an interest in a transferee partnership that holds the same contributed section 704(c) property. The limitations on this exception ensure that the partner's basis in the transferee partnership attributable to the contributed property is the same as the partner's basis in the transferor partnership attributable to that property. This allows a partnership to engage in a divisive split-up transaction, while preventing any avoidance of section 737 that might occur as a result of the basis allocation rules for non-liquidating distributions.

The proposed regulations provide that section 737 does not apply to an incorporation of a partnership other than an incorporation involving an actual distribution of partnership property to the partners. One commentator suggested that this distinction between methods of incorporation creates an unnecessary trap for the unwary and may have a chilling effect on the conversion of partnerships into S corporations. The final regulations adopt the proposed regulations without change. The form of incorporation chosen by the partners is respected for Federal tax purposes and, as a result, the distribution of property in connection with the incorporation is treated as a distribution for purposes of section 737.