

REPORT #752

TAX SECTION

New York State Bar Association

REPORT ON PROPOSED REGULATIONS  
IMPLEMENTING NOTICE 89-37

March 3, 1993

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# TAX SECTION

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Michael P. Dolan  
Acting Commissioner  
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Dear Commissioner Dolan:

Enclosed is a report of our Corporations Committee dealing with proposed regulations under Section 337(d) of the Internal Revenue Code which implement Notice 89-37. The report was drafted by Steven C. Todrys, Co-chair of the Committee on Corporations.

The proposed regulations deal with the recognition of gain by a corporate partner in connection with (i) the deemed exchange by that corporate partner, through the partnership, of appreciated property for its stock; and (ii) the receipt of stock of the corporate partner in exchange for the corporate partner's interest in the partnership. Both situations were also the subject of Notice 89-37.

The enclosed report reiterates the conclusions reached in our prior report on Notice 89-37 - i.e. support for the first rule described above and disagreement with the second. In addition, the report deals with certain clarifications which we believe should be incorporated in the first rule when included in a final regulation.

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Michael P. Dolan  
Acting Commissioner  
Internal Revenue Service  
March 9, 1993  
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We hope the report will be of help in drafting final regulations. If you have any questions, please call Steven Todrys or the undersigned.

Very truly yours,

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REPORT ON PROPOSED REGULATIONS  
IMPLEMENTING NOTICE 89-37<sup>1/</sup>

New York State Bar Association Tax Section  
Committee on Corporations

March 3, 1993

I. Background

On December 15, 1992, the Internal Revenue Service issued a Notice of Proposed Rulemaking (PS-91-90) containing proposed regulations under section 337(d) of the Internal Revenue Code implementing Notice 89-37, 1989-1 C.B. 679. The Notice was issued to prevent the use of partnerships to circumvent repeal of the General Utilities doctrine when (i) a corporate partner receives a partnership distribution of its own stock (the "Distribution Rule") and (ii) a pre-distribution transaction has the effect of an exchange of appreciated property by a corporate partner for its own stock (the "Deemed Redemption Rule").

The Tax Section issued a report on Notice 89-37 on November 14, 1989 (the "Report").<sup>2/</sup> The Report concluded that the

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<sup>1/</sup> This report was written by Steven C. Todrys, Co-Chair of the Committee on Corporations. Helpful comments were received from William Brannan, Peter Canellos, John Corry, Stephen Land, Stephen Millman, Yaron Reich, Michael Schler and Dana Trier.

<sup>2/</sup> "Report on Notice 89-37," 46 Tax Notes 99 (January 1, 1990).

Deemed Redemption Rule was an appropriate exercise of authority under section 337(d), but that the Distribution Rule, in adopting an entity approach to partnership taxation, was inconsistent with the Deemed Redemption Rule because it taxed a corporate partner on further appreciation in stock that it was already treated as having redeemed.<sup>3/</sup> - The Report recommended a modified distribution rule to deal with the shift in basis among distributed assets that can occur under section 732. The modified distribution rule would tax a corporate partner to the extent that the basis of its stock that it received in a distribution determined under the normal section 732 rules was less than the basis of that stock to the partnership. The Report also supported the Distribution Rule as a transition rule to deal with distributions from partnerships where a prior transaction would have been subject to the Deemed Redemption Rule but for its effective date. Finally, the Report made a series of technical suggestions for the regulations.

## II. The Proposed Regulations

The proposed regulations reject the primary recommendation of the Report that the Distribution Rule be modified. The Preamble states that "[t]he Service considered the modified distribution rule, but rejected that approach because the [D]istribution [R]ule is more administrable and requires less complex rules."

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<sup>3/</sup> The Deemed Redemption Rule applies to the extent that a distribution results in the receipt by a corporate partner of stock not previously allocated to it. Thus, in the case of a disproportionate distribution, the Deemed Redemption Rule will first apply to the increased share of stock then allocable to the corporate partner, leaving the Distribution Rule to apply only to stock previously allocated to the corporate partner.

The proposed regulations contain two basic rules: (i) "a partner recognizes gain when it is treated as increasing its interest in its own stock in exchange for appreciated property (the deemed redemption rule)" and (ii) "if the partnership distributes stock of a partner to the partner, the partner is treated as redeeming its stock for a portion of its partnership interest and recognizes gain, if any (the distribution rule)." Prop. Reg. § 1.337(d)-3(a). The general rules are to be "applied in a manner that is consistent with and reasonably carries but the purposes of" the proposed regulations -- "to prevent corporate taxpayers, through the use of a partnership, from avoiding gain required to be recognized under sections 311 or 337(d)." Prop. Reg. § 1.337(d)-3(b).

The Deemed Redemption Rule applies "at the time of, and to the extent that, any transaction has the economic effect of an exchange by a partner of its interest in appreciated property for an interest in the stock of the partner." Prop. Reg. § 1.337(d)-3(d)(1). Examples of such transactions include a contribution of property by a corporate partner to a partnership that owns its stock, the acquisition by a partnership of stock of a corporate partner, a disproportionate distribution of such stock, amendments to the partnership agreement to provide different sharing ratios and events that make the de minimis rule which is contained in the proposed regulations no longer applicable. Id.

If the Deemed Redemption Rule applies, "appropriate adjustments in basis are made." Prop. Reg. § 1.337(d)-3(d)(2). A partner's interest in its own stock "is determined based on all the facts and circumstances, including allocations and distribution rights." Prop. Reg. § 1.337(d)-3(d)(3). As we recommended in the Report, the definition of "stock" has been expanded to include other equity interests such as options,

warrants and similar interests, and includes stock of the partner or an affiliate. Prop. Reg. § 1.337(d)-3 (c).<sup>4/</sup> Affiliation is determined under section 1504(a), without regard to the exceptions in section 1504(b), and is tested (under Notice 93-2) immediately before the, deemed redemption or distribution. Id.

Under the Distribution Rule, the distribution to a partner of its own stock "is treated as a redemption or an exchange of the stock of the partner for a portion of the partner's partnership interest with a value equal to the stock distributed- Section 311 or 1001 rather than section 731 applies to that portion of the distribution." Prop. Reg. § 1.337(d)-3(e)(1). Section 732 does not apply to such a distribution and, if part of a larger distribution, the distribution of stock is treated as a separate transaction that occurs before the distribution of other property. Prop. Reg. § 1.337(d)-3(e)(2).

The proposed regulations also adopt a de minimis rule where (i) the corporate partner never owned more than five percent of the partnership and (ii) the partnership has not held the lesser of \$250,000 of stock of the partner or two percent of the value of any class of stock of the partner. In addition,

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<sup>4/</sup> The Service has also issued Revenue Ruling 93-7, dealing with the acquisition by a partnership of indebtedness of a partner and its subsequent distribution of that indebtedness to the partner. The ruling does not treat the acquisition of the debt by the partnership as a deemed repayment by the debtor partner. (The ruling indicates that the debt was purchased at par and that the partnership was not related to the partner within the meaning of section 108(e)(4), thus avoiding cancellation of indebtedness issues at the time of purchase under the deemed retirement rule of section 108(e)(4).) On distribution of the indebtedness, the debtor partner recognizes gain or loss to the extent the value of the indebtedness differs from the basis of the indebtedness determined under section 732. In addition, the debtor partner is treated as having satisfied the indebtedness at its fair market value. Therefore, the debtor partner realizes discharge of indebtedness income or deductible repurchase premium to the extent the fair market value of the debt differs from its issue price.

inadvertent ownership of the stock of a corporate partner can be cured if the stock is disposed of (other than by distribution to the partner or affiliate) prior to the due date of the partnership's return for the taxable, year in which the stock is acquired (or in which the corporation became a partner). Prop. Reg. § 1.337(d)-3(f).

### III. Comments

#### A. The Distribution Rule

A simple example illustrates the problem with the Distribution Rule.

Example: A corporation, C, and an individual, A, form an equal partnership. Each contributes \$100 cash which is used to purchase C stock. The partnership acquires no other assets. When the C stock has appreciated to \$1000, it is distributed pro rata to C and A.

Because there was no deemed exchange by C of appreciated property for its stock at the time of the formation of the partnership, the Deemed Redemption Rule has no effect. However, under the Distribution Rule, the distribution of the C stock to C is treated as a redemption of that stock in exchange for C's partnership interest and C recognizes gain of \$400 (the excess of the \$500 value of the C stock distributed over C's \$100 basis in its partnership interest) under section 311. This gain is taxed even though it is solely attributable to C's pro rata share of appreciation in the C stock and not to the exchange by C of any other appreciated property for its stock<sup>5/</sup> We do not believe that repeal of the General Utilities doctrine supports a

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<sup>5/</sup> The proposed regulations take the view that C's partnership interest is the appreciated asset exchanged for the C stock, but that does not seem appropriate to the extent the appreciation in the partnership interest relates to the C stock.

regulation that taxes a corporate partner on its share of appreciation in its own stock and, therefore, we continue to urge the modification of the Distribution Rule proposed in the Report. We also believe that the Distribution Rule, premised as it is on an entity approach to the holding of partner stock by a partnership, undermines to some extent the rationale of the Deemed Redemption Rule which looks through the partnership to determine that a partner's stock was indirectly redeemed.

In maintaining our opposition to the Distribution Rule, we recognize that Notice 89-37 and the proposed regulations are intended to prevent abusive (and commercially unusual)<sup>6/</sup> transactions. We also appreciate the Service's interest in administrative simplicity. However, the scope of the Distribution Rule is overbroad and, as such, we believe it is bad tax policy. The modified Distribution Rule proposed in the Report closes the gaps that remain in the Deemed Redemption Rule and is not, in our view, unduly complex.

#### B. Example 2

Example 2 of the proposed regulations illustrates the application of the Deemed Redemption Rule when stock of the corporate partner is acquired by the partnership after the partnership's assets have appreciated. C, a corporation, and A, an individual, form an equal partnership to which each contributes assets with a basis and value of \$100 (i.e., there is no pre-contribution appreciation in the contributed

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<sup>6/</sup> Legitimate business transactions can involve the contribution of a corporate partner's stock to a partnership. For example, a corporate partner might capitalize a joint venture with its stock to support a borrowing by the venture. The corporate partner should not be taxed on appreciation in that stock upon its return at the conclusion of the project.

property). Thereafter, the assets appreciate to \$400 and the partnership purchases C stock for \$100.<sup>7/</sup> Example 2 concludes that the purchase of C stock triggers the Deemed Redemption Rule. C is treated as redeeming \$50 worth of C stock (its share of the C stock under the partnership agreement) in exchange for \$50 worth of its partnership interest. Since C's partnership interest has a total value of \$200 and basis of \$100, the redemption relates to one-fourth of C's partnership interest with a basis of \$25. Therefore, C recognizes gain of \$25 and its basis in the partnership is increased to \$125.

Had the C stock been acquired upon formation of the partnership, the Deemed Redemption Rule would have been applicable but no gain would have been recognized by C since the assets contributed by C were not appreciated. Moreover, subsequent appreciation in the assets of the partnership would not have triggered a later application of the Deemed Redemption Rule, absent some shift in sharing ratios.

Because the appreciation in the assets of the partnership is shared equally by C and A, Example 2 is the equivalent of the formation of a new partnership between C and A to which each contributes appreciated property (basis of \$50 and value of \$150) and C stock (basis and value of \$50). On those facts, C is not increasing its interest in its own stock in exchange for appreciated property as required by Prop. Reg. §

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<sup>7/</sup> The example does not specify the source of funds used to purchase the C stock. However, it should not matter whether the cash was borrowed, originally contributed by one or both partners or generated by partnership operations because the partners have a pro rata interest in all of the assets (and liabilities) of the partnership, and in the appreciation in those assets.

1.337(d)-3(a).<sup>8/</sup> Absent a shift in the economic ownership of the appreciated property from C to A in exchange for the C stock contributed by A, we do not believe that the application of the Deemed Redemption Rule is justified.

The Report addressed this issue in a slightly different context. Example 11 in the Report<sup>9/</sup> deals with the case in which a corporate partner contributes appreciated property, and an individual contributes cash, to an equal partnership. The partnership generates taxable income of \$100 with which it purchases stock of the corporate partner. We concluded, consistent with our recommendation above, that the Deemed Redemption Rule should not apply to the purchase of stock because the corporate partner did not economically reduce its interest in the appreciated property in exchange for its stock. Rather, it used its pro rata share of partnership income to acquire the stock.

There are circumstances in which the post-formation purchase of the stock of a corporate partner should trigger the Deemed Redemption Rule. For example, if in Example 11 in the Report, the stock of the corporate partner had been purchased prior to the partnership earning \$100 (e.g., with the cash contributed by the individual partner), the Deemed Redemption Rule should apply. Since money is fungible, we would not,

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<sup>8/</sup> One could argue that there has been an economic exchange of one-half of the property that C contributed to the partnership for one-half of the property contributed by A. Thus, C would have exchanged \$25 of C stock and \$75 of appreciated assets (with a basis of \$25) for \$25 of C stock and \$75 of appreciated assets contributed by A. Under this formulation, C should only be treated as receiving \$18.75 of C stock contributed by A in exchange for appreciated assets. We would not, however, support this formulation where each partner is contributing a pro rata share of each asset because C is not increasing its interest in C stock.

<sup>9/</sup> 46 Tax Notes 99, 107 (January 1, 1990).

however, advocate a tracing rule to determine the source of funds for the purchase of stock of the corporate partner. Instead, the regulations could exclude the purchase of stock of a corporate partner from the Deemed Redemption Rule to the extent of each partner's share of the, retained income of the partnership.<sup>10/</sup>

Alternatively, the regulations could apply the Deemed Redemption Rule to post-formation purchases of stock under concepts similar to the disguised sale analysis under section 707. As we noted in the Report, the contribution of different properties to a partnership involves an exchange of economic interests in the properties among the partners.<sup>11/</sup> Thus, if a corporate partner contributes appreciated property and another partner contributes cash to a partnership, an "exchange" of a portion of the appreciated property for cash has occurred. This economic exchange does not, however, result in current taxation under section 721. Once the "exchange" under section 721 is "old and cold," a subsequent purchase of stock of the corporate partner does not result in another exchange of appreciated property by the corporate partner. The exchange of appreciated property occurred in a nontaxable manner at the earlier formation of the partnership.<sup>12/</sup>

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<sup>10/</sup> The retained income of the partnership would be its income (including items that increase basis under section 705) reduced by distributions on a cumulative basis up to the time of the stock purchase. We would not extend this rule to stock of the corporate partner purchased with funds provided by borrowings (even though borrowings increase basis) because of the difficulty in monitoring the source of the repayment of those borrowings.

<sup>11/</sup> Id. at 101.

<sup>12/</sup> Even if the acquisition of stock did not trigger the Deemed Redemption Rule, the modified Distribution Rule described in the Report would tax the corporate partner on any step-down in basis in its stock which it received in a subsequent pro rata distribution.

### C. Example 3

Example 3 of the proposed regulations illustrates the application of the rules to a contribution by a corporate partner of both gain and loss property. C contributes two assets: Asset 1 with a value of \$90 and a basis of \$9 and Asset 2 with a value of \$9 and a basis of \$90, to an equal partnership with A and B. A contributes C stock with a basis and value of \$99 and B contributes \$99 cash. Example 3 concludes that, under the Deemed Redemption Rule, C is treated as exchanging a portion of Asset 1 with a \$33 value and a \$3.30 basis for C stock worth \$33, resulting in gain of \$29.70. To reach this result, Example 3 must assume that C's one-third share of the C stock contributed by A is deemed exchanged solely for Asset 1.<sup>13/</sup>

We believe that Example 3 should treat the C stock as exchanged for a portion of both Asset 1 and Asset 2, in proportion to their relative fair market values. Thus, \$30 of C stock would be deemed exchanged for \$30 of Asset 1 and \$3 of C stock would be deemed exchanged for \$3 of Asset 2.<sup>14/</sup> C would recover \$3 of basis (30/90) in Asset 1, resulting in \$27 of gain. No loss would be recognized with respect to the portion of Asset 2 deemed exchanged for C stock.

Example 3 does not address the determination of C's basis in its partnership interest. While C's basis should be increased by the gain recognized with respect to Asset 1, it should also be reduced by the basis of any portion of Asset 2

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<sup>13/</sup> Because the C stock is attributed solely to the appreciated asset, C is entitled to recover 33/90ths of its \$9 basis in Asset 1, or \$3.30.

<sup>14/</sup> The \$33 of C stock is attributable 90/99ths to Asset 1 (\$30) and 9/99ths to Asset 2 (\$3). The cash contributed by B should not affect those ratios.

deemed exchanged for C stock. Otherwise, C could recognize the loss inherent in Asset 2 (which would have been disallowed under section 311) by selling its partnership interest.<sup>15/</sup>

#### D. Miscellaneous

Additional examples. The examples contained in the proposed regulations deal with only the simplest cases. It might be useful to consider additional examples dealing, for instance, with disproportionate distributions (Example 2 of the Report) and non pro rata partnerships (Examples 7,8,9 and 10 of the Report),, although the increase in complexity engendered would have to be weighed against the clarification achieved.

Treatment of other partners. It would also be useful if the regulations explicitly stated that the deemed redemption of stock by a corporate partner is not treated as a redemption to the other partners (See Example 5 of the Report).

Basis allocation. To determine its gain under the Distribution Rule, a corporate partner must allocate its basis in its partnership interest between the stock distributed and its share of the partnership's other assets. Under the proposed regulations, basis is allocated in proportion to the relative fair market values of such stock and other assets. Prop. Reg. § 1.337(d)-3(e)(1). We believe that this basis allocation rule is reasonable, although the Report suggested an allocation in

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<sup>15/</sup> Assume that, in Example 3, C retained a 1% partnership interest (i.e., it received a distribution of only \$98 of C stock). The \$80 gain on Asset 1 recognized under the Deemed Redemption Rule would increase C's basis in its partnership interest to \$179. Under sections 732(a)(1) and 733(2), C's basis in its partnership interest would be reduced only by the partnership's basis (\$98) in the C stock distributed. C would then own a partnership interest with a basis of \$81 and a value of \$1. The loss it would realize on a sale of the partnership interest is the loss disallowed under section 311 on the deemed exchange of Asset 2.

proportion to the partnership's basis in the assets, rather than their fair market value.

Section 737. Transactions subject to the proposed regulations may also be subject to section 737. The computation of "net precontribution gain" under section 737 should take account of any gain recognized under the proposed regulations.