



1 of 4 DOCUMENTS

DEPARTMENT OF THE TREASURY

Treasury Decision 8902

Capital Gains, Partnership, Subchapter S, and Trust Provisions

2000-2 C.B. 323; T.D. 8902; 2000 IRB LEXIS 428; 2000-41 I.R.B. 323

October 10, 2000

[*1]

SUBJECT MATTER: Section 1-Tax Imposed

APPLICABLE SECTIONS:

26 CFR 1.1 (h)-1. Capital gains look-through rule for sales or exchanges of interests in a partnership, S corporation, or trust. Internal Revenue Service 26 CFR Parts 1 and 602

TEXT:

AGENCY:

Internal Revenue Service (IRS). Treasury.

ACTION:

Final regulations.

SUMMARY:

This document contains final regulations relating to sales or exchanges of interests in partnerships, S corporations, and trusts. The regulations interpret the look-through provisions of *section 1 (h)*, added by section 311 of the Taxpayer Relief Act of 1997 and amended by sections 5001 and 6005 (d) of the Internal Revenue Service Restructuring and Reform Act of 1998, and explain the rules relating to the division of the holding period of a partnership interest. The regulations affect partnerships, partners, S corporations, S corporation shareholders, trusts, and trust beneficiaries.

DATES:

Effective Date: These regulations are effective September 21, 2000.

FOR FURTHER INFORMATION CONTACT: Jeanne M. Sullivan or David J. Sotos (202) 622-3050 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by [*2] the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507) under

control number 1545-1654. Responses to these collections of information are required to verify compliance with section 1 (h) and to determine that the tax on capital gains has been computed correctly.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number assigned by the Office of Management and Budget.

The estimated annual burden per respondent/recordkeeper is 10 minutes.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to this collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return [*3] information are confidential, as required by 26 U.S.C. 6103.

Background

Section 311 of the Taxpayer Relief Act of 1997, Public Law 105-34 (111 Stat. 788, 831) (the 1997 Act), as modified by sections 5001 and 6005 (d) of the Internal Revenue Service Restructuring and Reform Act of 1998, Public Law 105-206 (112 Stat. 685, 787, 800) (the 1998 Act), reduced the maximum statutory tax rates for long-term capital gains of individuals in general and provided regulatory authority to apply the rules to sales and exchanges of interests in pass-thru entities and to sales and exchanges by pass-thru entities. On August 9, 1999, the IRS published in the **Federal Register** a notice of proposed rulemaking (REG-106527-98, 1999-34 I.R.B. 304 [64 F.R. 43117]) relating to the taxation of capital gains in the case of sales or exchanges of interests in partnerships, S corporations, and trusts. The regulations interpreted rules added by the 1997 Act and amended by the 1998 Act, and provided guidance relating to the division of the holding period of a partnership interest. The IRS received no requests to speak at a public hearing that was scheduled for November 18, 1999, and canceled the hearing. Written comments [*4] were received in response to the notice of proposed rulemaking. After consideration of the comments, the proposed regulations under sections 1 (h), 741, and 1223 are adopted, as revised by this Treasury decision. The comments received and revisions made are discussed below.

Explanation of Revisions and Summary of Comments

1. Look-Through Capital Gain

a. In General

Section 1 (h) provides maximum capital gains rates in three categories: 20-percent rate gain, 25-percent rate gain, and 28-percent rate gain. Twenty percent rate gain is net capital gain from the sale or exchange of capital assets held for more than one year, reduced by the sum of 25-percent rate gain and 28-percent rate gain. Twenty-five percent rate gain is limited to unrecaptured *section 1250* gain. Twenty-eight percent rate gain includes capital gains and losses from the sale or exchange of collectibles (as defined in *section 408 (m)* without regard to *section 408 (m) (3)*) held for more than one year and certain other types of gain.

Capital gain attributable to the sale or exchange of an interest in a pass-thru entity held for more than one year generally is in the 20-percent rate gain category. However, the proposed regulations [*5] provide that, when a taxpayer sells or exchanges an interest in a partnership, S corporation, or trust that holds collectibles, rules similar to the rules under *section 751 (a)* apply to determine the capital gain that is attributable to certain unrealized gain in the collectibles. Furthermore, under the proposed regulations, rules similar to the rules under *section 751 (a)* also apply to determine the capital gain attributable to certain unrealized gain in *section 1250* property held by a partnership when a taxpayer sells or exchanges an interest in a partnership that holds such property.

b. Net Collectibles Loss

Twenty-eight percent rate gain is the excess (if any) of (i) the sum of collectibles gain and *section 1202* gain, over (ii) the sum of collectibles loss, the net short-term loss, and the amount of long-term capital loss carried under *section 1212 (b) (1) (B)* to the taxable year. One commentator suggested that, when an interest in a partnership, S corpora-

tion, or trust is transferred, net collectibles loss as well as net collectibles gain in property held by such an entity should be taken into account in determining a taxpayer's overall collectibles gain or collectibles loss. The [*6] Treasury Department (Treasury) and the IRS believe that the proposed regulations are consistent with the rule in *section 1 (h) (6) (B)*, which, in providing look-through treatment with respect to collectibles, refers only to "gain from the sale of an interest in a partnership, S corporation, or trust which is attributable to unrealized appreciation in the value of collectibles ..." Accordingly, the comment is not adopted in the final regulations.

c. Limitations with Respect to Section 1231 Property

Section 1 (h) (7) (B) limits the amount of unrecaptured *section 1250* gain recognized as a consequence of sales, exchanges, and conversions described in *section 1231 (a) (3) (A)* to the taxpayer's net *section 1231* gain (as defined in *section 1231 (c) (3)*) for the taxable year. The proposed regulations provide that, upon a partner's transfer of a partnership interest, the partner's allocable share of *section 1250* capital gain (as defined in § 1.1 (h)-1 (b) (3)) is not treated as *section 1231* gain for purposes of applying the limitation in *section 1 (h) (7) (B)*. There has been some confusion regarding whether the *section 1 (h) (7) (B)* limitation applies to all unrecaptured *section 1250* gain, including [*7] *section 1250* capital gain recognized on the transfer of a partnership interest.

Because the transfer of an interest in a partnership is not described in *section 1231 (a) (3) (A)*, the limitation provided in *section 1 (h) (7) (B)* is not applicable with respect to such transfers. Accordingly, under the final regulations (and consistent with the proposed regulations), where a partner sells an interest in a partnership, the partner must take into account the entire allocable share of *section 1250* capital gain in determining the unrecaptured *section 1250* gain under *section 1 (h) (7) (A)*, without regard to the limitation set forth in *section 1 (h) (7) (B)*.

d. Redemption of a Partnership Interest

Some practitioners have expressed concern that the look-through capital gains provisions of the proposed regulations apply to the redemption of a partnership interest. To apply the regulations in the context of redemptions, it would be necessary to import the concepts utilized in *section 751 (b)*. Treasury and the IRS believe that this would not be advisable. Accordingly, these regulations do not apply to any transaction that is treated as a redemption of a partnership interest for Federal income tax [*8] purposes.

e. Allocating Section 704 (c) Gain and Loss

Certain commentators requested that the final regulations provide guidance with respect to the proportionate part of the *section 704 (c)* built-in gain or loss that is transferred to the purchaser when a *section 704 (c)* partner sells a portion of a partnership interest. This issue is relevant because, in determining a taxpayer's share of collectibles gain or *section 1250* capital gain on the sale of a partnership interest, it is necessary to calculate how much of such gain would be allocated with respect to the partnership interest sold if the underlying collectibles or *section 1250* property held by the partnership were sold for their fair market value. In making this determination where a partner sells only a portion of its interest in a partnership, it is necessary to determine how much *section 704 (c)* gain relating to collectibles or *section 1250* property is allocable to the portion of the partnership interest that is sold. Although relevant, Treasury and the IRS believe that this issue is beyond the scope of these regulations. Accordingly, this comment is not addressed in these regulations.

f. Look-Through Capital Gain Where the Pass-Thru Entity Has a Short-Term Holding Period in Collectibles

The [*9] final regulations modify the proposed regulations to provide that a pass-thru entity's holding period in the collectibles is not relevant in determining whether long-term capital gain recognized on the sale of an interest in the entity is collectibles gain (taxable at a 28-percent rate). Consistent with the purpose of the look-through provisions contained in *section 1 (h)*, these regulations characterize a transferor's long-term capital gain recognized on the sale of the interest in a pass-thru entity by reference to the entity's underlying assets that give rise to such gain. Where a transferor recognizes long-term capital gain on the sale of an interest in a partnership, S corporation, or trust, it would be anomalous to provide the transferor with a better tax result if the entity has a short-term holding period in collectibles than if the entity has a long-term holding period in such property. This rule is not relevant with respect to *section 1250* property. Because all depreciation with respect to *section 1250* property held for one year or less is treated as additional depreciation under *section 1250 (b) (1)*, such amounts will be treated as unrealized receivables under *section 751 (c)* [*10] and thus will give rise to ordinary income under *section 751 (a)* upon a disposition of the partnership interest.

2. Determination of Holding Period in a Partnership

a. In General

The proposed regulations provide rules relating to the allocation of a divided holding period with respect to an interest in a partnership. These rules generally provide that the holding period of a partnership interest will be divided if a partner acquires portions of an interest at different times or if an interest is acquired in a single transaction that gives rise to different holding periods under *section 1223*. Under the proposed regulations, the holding period of a portion of a partnership interest generally is determined based on a fraction that is equal to the fair market value of the portion of the partnership interest to which the holding period relates (determined immediately after the acquisition) over the fair market value of the entire partnership interest.

Under the proposed regulations, a selling partner generally cannot identify and use the actual holding period for a portion of the partner's interest. However, the proposed regulations provide that a selling partner is permitted to identify the [*11] portion of a partnership interest sold with its holding period if the partnership is a publicly traded partnership (as defined under *section 7704 (b)*), the partnership interest is divided into identifiable units with ascertainable holding periods, and the selling partner can identify the portion of the interest transferred.

b. Contributions of Cash by Existing Partners

The proposed regulations include an example of a pro rata contribution of cash by partners that results in a divided holding period in those partners' interests in the partnership. Commentators suggested that it is inappropriate to provide for a divided holding period where an existing partner contributes cash to the partnership, particularly where the contribution is pro rata by all of the partners. According to these commentators, such an approach may unfairly convert portions of long-term appreciation of partnership assets into a short-term capital gain on the sale of a long held partnership interest. (This conversion occurs regardless of whether the partner sells all or a portion of a partnership interest.)

The conversion of long-term appreciation in partnership assets into short-term capital gain upon the sale of a [*12] partnership interest as a result of cash contributions to the partnership is largely the product of partners having unitary bases in their partnership interests. See *Rev. Rul. 84-53 (1984-1 C.B. 159)* (a partner has a single basis in a partnership interest). Under this rule, gain attributable to previously contributed or acquired assets may be allocated to the short-term portion of a partnership interest even though the value of the short-term portion is no greater than the amount of cash contributed to the partnership. If basis from contributed cash or property could be traced to a segregated interest in the partnership, this conversion of long-term capital appreciation into short-term capital gain would not occur. Larger problems would arise, however, in the context of partnership taxation if a partner were allowed to have a divided basis in a partnership interest.

An aggregate approach to determining the holding period of an interest in a partnership would make it more likely that a contribution of cash would not give rise to a short-term holding period. Under an aggregate approach, one could trace contributed funds into the partnership and determine whether a new holding period was [*13] created by reference to whether the funds were used for capital expenditures (in which circumstance, a short-term holding period generally would be appropriate) or for operating expenditures of the partnership (in which circumstance, no new holding period should be created). On the other hand, to the extent that a partnership interest is a capital asset that is distinct from the partnership's assets (an entity approach), its holding period and basis should be determined independently and should not be affected by the partnership's use of the contributed funds. In choosing the entity approach in the proposed regulations, Treasury and the IRS concluded that tracing funds to their ultimate use in the partnership is not an administrable means of determining whether a contribution to a partnership creates a new holding period.

Furthermore, the proposed regulations are consistent with general rules relating to the holding period of capital and *section 1231* assets. Where a capital asset (including a capital asset held for one year or less) or property described in *section 1231* is contributed to a partnership, *section 1223 (1)* requires the tacking of the holding period in the partnership interest, [*14] whether the partners make pro rata contributions of property or instead make non-pro rata contributions that increase the proportionate interests of one or more partners.

In addition, the proposed regulations avoid inappropriate results that may occur if cash contributions are ignored after the formation of a partnership. If cash contributions were ignored, it would be possible for partners to form shelf partnerships with nominal cash contributions in order to start their holding period in the interests, where the majority of

cash would not be contributed (and significant operating assets of the partnership would not be acquired) until some time in the future. This clearly would not be a proper result.

Based upon the foregoing, Treasury and the IRS continue to believe that the approach taken in the proposed regulations is appropriate. However, in response to comments, Treasury and the IRS have provided one exception, and explicitly grant authority for another, where the contribution of cash will not create a new holding period in a partnership interest.

If a partner makes cash contributions and receives cash distributions from a partnership during the one-year period before sale of all [*15] or a portion of the interest in the partnership, Treasury and the IRS believe it is appropriate that the net cash contribution to the partnership determine the portion of the interest that is held for one year or less. Therefore, the final regulations provide that, if a partner makes one or more cash contributions and receives one or more cash distributions with respect to the partnership during the one-year period ending on the date of the sale or exchange of all or a portion of the partner's interest in the partnership, in applying the rules for determining the partner's holding period in its partnership interest with respect to cash contributions, the partner may reduce the cash contributions made during the year by cash distributions received on a last-in-first-out basis, treating all cash distributions as if they were received by the partner immediately before the sale or exchange. This rule also applies in determining the holding period of a partnership interest where gain or loss is recognized under *section 731 (a)* upon a distribution by the partnership.

In addition, the final regulations include authority for the Secretary to provide, in published guidance, additional exceptions [*16] to the general holding period rules with respect to other cash contributions, including *de minimis* cash contributions, to a partnership. Treasury and the IRS request comments as to the appropriate level for a *de minimis* exception.

c. Treatment of Deemed Cash Contributions under Section 752 (a)

Section 752 (a) provides that an increase in a partner's share of partnership liabilities, or an increase in a partner's individual liabilities by reason of the partner's assumption of partnership liabilities, shall be treated as a contribution of money by the partner to the partnership. Some practitioners have questioned whether a partner's deemed contribution of cash under *section 752 (a)* will give rise to a new holding period in that partner's interest in the partnership. A deemed contribution of cash resulting from a shift among partners in their share of liabilities or as a result of a partnership incurring new debt does not expand the net asset base of the partners represented by their interests, in the partnership. Accordingly, it is inappropriate to create a new holding period as a result of such deemed contributions. However, to the extent that a partner actually assumes a debt of the [*17] partnership, thus causing an increase in the net asset base of the partnership, the creation of a new holding period with respect to a portion of the partner's interest is appropriate.

In addressing a similar issue, the capital account rules regarding the treatment of liabilities under § 1.704-1 (b) (2) (iv) (c) attempt to measure the increase or decrease in a partner's economic interest in the partnership resulting from the assumption of liabilities by either the partner or the partnership. Those rules provide:

(1) money contributed by a partner to a partnership includes the amount of any partnership liabilities that are assumed by such partner (other than [certain] liabilities ... that are assumed by a distributee partner [in connection with a distribution of property by the partnership]) but does not include increases in such partner's share of partnership liabilities (see *section 752 (a)*), and (2) money distributed to a partner by a partnership includes the amount of such partner's individual liabilities that are assumed by the partnership (other than [certain] liabilities... that are assumed by the partnership [in connection with a contribution of property to the partnership]) but [*18] does not include decreases in such partner's share of partnership liabilities (see *section 752 (b)*)...

This rule is incorporated in the final regulations. The final regulations provide that deemed contributions and distributions of cash under *sections 752 (a)* and *(b)* will be disregarded in determining a partner's holding period in its partnership interest to the same extent that such amounts are disregarded under § 1.704-1 (b) (2) (iv) (c). (Deemed distributions under *section 752 (b)* are relevant as a result of the cash netting rule added in these final regulations.)

d. Contribution of Section 751 Assets

Commentators noted that, if a partner has a short-term holding period in a partnership interest on account of the contribution of assets described in *section 751 (c) or (d)* (section 751 assets), the rules of *section 751 (a)* in conjunction with the proposed regulations cause the section 751 assets to be counted twice if a partnership interest is sold within 12 months of the contribution, once in applying *section 751 (a)* to treat part of the amount received as ordinary income, and again in determining the selling partner's short-term capital gain. In response to these comments, the final [*19] regulations provide that, if a partner recognizes ordinary income or loss on account of section 751 assets, either under *section 751 (a)* as a result of the sale of all or part of the partnership interest or as a result of the sale by the partnership of the section 751 assets, the section 751 assets shall be disregarded in determining the division of the holding period of an interest in a partnership upon a sale of such partnership interest during the one-year period following the contribution. This rule does not apply if, in the absence of the rule, a partner would not be treated as having held any portion of the interest for more than one year. Accordingly, if a partner's only contributions to a partnership are contributions of section 751 assets or section 751 assets and cash within the prior one-year period, the adjustment will not be available, and the partner appropriately will be treated as having a short-term holding period with respect to the entire interest.

A similar rule disregarding the contribution of section 751 assets does not apply in determining the holding period of a partnership interest with respect to gain or loss recognized under *section 731* upon a distribution [*20] by a partnership. Properly coordinating the holding period rules with gain or loss determinations under *section 751 (b)* would be inordinately complex. In addition, where, within a one-year period, a partner contributes section 751 assets to a partnership and receives a cash distribution large enough to require the recognition of gain, it is likely that the contribution and distribution will constitute a disguised sale of the section 751 assets to the partnership under *section 707 (a) (2) (B)*, thus rendering the holding period rules irrelevant since the sale of an asset to a partnership does not affect the holding period of an interest in the partnership.

e. Treatment of Recapture and Other Unrealized Receivables

An example in the proposed regulations treats the portion of a contributed asset that would be recaptured as ordinary income under *section 1245* upon disposition as non-*section 1231* property for purposes of the tacked holding period rule in *section 1223 (1)*. Some commentators have raised questions regarding the position taken in this example. For purposes of these regulations, Treasury and the IRS believe that it is appropriate to characterize all properties and potential gain [*21] treated as unrealized receivables under *section 751 (c)* and the regulations thereunder as separate assets that are not capital assets or property described in *section 1231*. Accordingly, while the example in the proposed regulations has been eliminated, a specific rule has been added in the final regulations to provide for such a result. This rule is consistent with the rule added in the final regulations regarding the holding period exception for contributed section 751 assets. As discussed above, that rule will disregard the contribution of section 751 assets (including properties and potential gain treated as unrealized receivables under *section 751 (c)*) in computing the holding period of a partnership interest where the interest is sold within one year after contribution. Accordingly, while *section 1245* recapture (and similar items treated as unrealized receivables) will be treated as a separate asset that is not a capital or *section 1231* asset, the asset will not give rise to a short-term holding period where a partnership interest is sold. This rule also is similar to the rule contained in § 1.755-1 (a), which provides that properties and potential gain treated as unrealized receivables [*22] under *section 751 (c)* are considered separate ordinary income assets for purposes of allocating basis adjustments under *section 755*.

f. Identification of Publicly Traded Partnership Units

The proposed regulations provide that a selling partner may use the actual holding period of the portion of a partnership interest sold if the partnership is a "publicly traded partnership" (as defined under *section 7704 (b)*), the partnership interest is divided into identifiable units with ascertainable holding periods, and the selling partner can identify the portion of the interest transferred. Commentators suggested that it may be appropriate to provide that a partner must be consistent in electing, for holding period purposes, to identify units of a publicly traded partnership that are sold or exchanged in order to avoid distortion in the total long-term and short-term capital gain recognized. This suggestion is adopted in the final regulations.

g. Conversion from General Partnership to Limited Partnership

A commentator requested clarification that a partner's holding period in its partnership interest carries over when a partnership converts from a general partnership to a limited partnership, as [*23] described in *Rev. Rul. 84-52 (1984-1 C.B. 157)*. The ruling concludes that, pursuant to *section 1223 (1)*, there will be no change to the holding period of any partner's interest in the partnership as a result of such a conversion. The final regulations do not change the result set forth in *Rev. Rul. 84-52*.

h. Other Miscellaneous Issues

The proposed regulations contain an example which, consistent with *Rev. Rul. 84-53*, states that a partner has a single basis in its partnership interest. Certain commentators suggested that the principle that a partner has a single basis in its partnership interest should be set forth in regulations, rather than simply relying on *Rev. Rul. 84-53*. The rules set forth in these regulations address only holding period and character issues. In illustrating the operation of certain of these rules, the example accurately reflects current law. Treasury and the IRS believe that the inclusion of a separate rule providing that a partner has a single basis in its partnership interest is unnecessary and is beyond the scope of these regulations.

Finally, it was suggested that the final regulations cross-reference *section 83 (f)*, which provides that in determining the [*24] holding period of property to which *section 83 (a)* applies, only the holding period during which rights are transferable or are not subject to a substantial risk of forfeiture shall be included. Treasury and the IRS currently are studying the extent to which *section 83 (a)* applies to the issuance of certain partnership interests (i.e., a profits interest in a partnership) in exchange for services. *Section 83 (f)* is relevant to the extent that *section 83 (a)* applies with respect to a partnership interest. However, in order to avoid any implication that *section 83 (a)* applies to all partnership interests issued in exchange for services, a cross reference to *section 83 (f)* has not been included in the final regulations.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 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)* does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant impact on a substantial number [*25] of small businesses. This certification is based upon the fact that the economic burden imposed on taxpayers by the collection of information and recordkeeping requirements of these regulations is insignificant. For example, the estimated average annual burden per respondent is 10 minutes. Therefore, a Regulatory Flexibility Analysis is not required under the Regulatory Flexibility Act (*5 U.S.C. chapter 6*). Pursuant to *section 7805 (f) of the Internal Revenue Code*, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are Jeanne M. Sullivan and David J. Sotos of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from Treasury and the IRS participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are 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 in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.1 (h)-1 [*26] is also issued under 26 U.S.C. 1 (h);* * *

Par. 2. Section 1.1 (h)-1 is added to read as follows:

§ 1.1 (h)-1 Capital gains look-through

rule for sales or exchanges of interests in a partnership, S corporation, or trust.

(a) *In general.* When an interest in a partnership held for more than one year is sold or exchanged, the transferor may recognize ordinary income (e.g., under *section 751 (a)*), collectibles gain, *section 1250* capital gain, and residual long-term capital gain or loss. When stock in an S corporation held for more than one year is sold or exchanged, the transferor may recognize ordinary income (e.g., under *sections 304, 306, 341, 1254*), collectibles gain, and residual long-term capital gain or loss. When an interest in a trust held for more than one year is sold or exchanged, a transferor who is not treated as the owner of the portion of the trust attributable to the interest sold or exchanged (*sections 673 through 679*) (a non-grantor transferor) may recognize collectibles gain and residual long-term capital gain or loss.

(b) *Look-through capital gain* -(1) *In general.* Look-through capital gain is the share of collectibles gain allocable to an interest in a partnership, S corporation, [*27] or trust, plus the share of *section 1250* capital gain allocable to an interest in a partnership, determined under paragraphs (b) (2) and (3) of this section.

(2) *Collectibles gain* -(i) *Definition.* For purposes of this section, *collectibles gain* shall be treated as gain from the sale or exchange of a collectible (as defined in *section 408 (m)*) without regard to *section 408 (m) (3)* that is a capital asset held for more than 1 year.

(ii) *Share of collectibles gain allocable to an interest in a partnership, S corporation, or a trust.* When an interest in a partnership, S corporation, or trust held for more than one year is sold or exchanged in a transaction in which all realized gain is recognized, the transferor shall recognize as collectibles gain the amount of net gain (but not net loss) that would be allocated to that partner (taking into account any remedial allocation under § 1.704-3 (d)), shareholder, or beneficiary (to the extent attributable to the portion of the partnership interest, S corporation stock, or trust interest transferred that was held for more than one year) if the partnership, S corporation, or trust transferred all of its collectibles for cash equal to the fair market [*28] value of the assets in a fully taxable transaction immediately before the transfer of the interest in the partnership, S corporation, or trust. If less than all of the realized gain is recognized upon the sale or exchange of an interest in a partnership, S corporation, or trust, the same methodology shall apply to determine the collectibles gain recognized by the transferor, except that the partnership, S corporation, or trust shall be treated as transferring only a proportionate amount of each of its collectibles determined as a fraction that is the amount of gain recognized in the sale or exchange over the amount of gain realized in the sale or exchange. With respect to the transfer of an interest in a trust, this paragraph (b) (2) applies only to transfers by non-grantor transferors (as defined in paragraph (a) of this section). This paragraph (b) (2) does not apply to a transaction that is treated, for Federal income tax purposes, as a redemption of an interest in a partnership, S corporation, or trust.

(3) *Section 1250 capital gain* -(i) *Definition.* For purposes of this section, *section 1250 capital gain* means the capital gain (not otherwise treated as ordinary income) that

would [*29] be treated as ordinary income if *section 1250 (b) (1)* included all depreciation and the applicable percentage under *section 1250 (a)* were 100 percent.

(ii) *Share of section 1250 capital gain allocable to interest in partnership.* When an interest in a partnership held for more than one year is sold or exchanged in a transaction in which all realized gain is recognized, there shall be taken into account under *section 1 (h) (7) (A) (i)* in determining the partner's unrecaptured *section 1250* gain the amount of *section 1250* capital gain that would be allocated (taking into account any remedial allocation under § 1.704-3 (d)) to that partner (to the extent attributable to the portion of the partnership interest transferred that was held for more than one year) if the partnership transferred all of its *section 1250* property in a fully taxable transaction for cash equal to the fair market value of the assets immediately before the transfer of the interest in the partnership. If less than all of the realized gain is recognized upon the sale or exchange of an interest in a partnership, the same methodology shall apply to determine the *section 1250* capital gain recognized by the transferor, except [*30] that the partnership shall be treated as transferring only a proportionate amount of each *section 1250* property determined as a fraction that is the amount of gain recognized in the sale or exchange over the amount of gain realized in the sale or exchange. This paragraph (b) (3) does not apply to a transaction that is treated, for Federal income tax purposes, as a redemption of a partnership interest.

(iii) *Limitation with respect to net section 1231 gain.* In determining a transferor partner's net *section 1231* gain (as defined in *section 1231 (c) (3)*) for purposes of *section 1 (h) (7) (B)*, the transferor partner's allocable share of *section 1250* capital gain in partnership property shall not be treated as *section 1231* gain, regardless of whether the partnership property is used in the trade or business (as defined in *section 1231 (b)*).

(c) *Residual long-term capital gain or loss.* The amount of residual long-term capital gain or loss recognized by a partner, shareholder of an S corporation, or beneficiary of a trust on account of the sale or exchange of an interest in a partnership, S corporation, or trust shall equal the amount of long-term capital gain or loss that the partner would [*31] recognize under *section 741*, that the shareholder would recognize upon the sale or exchange of stock of an S corporation, or that the beneficiary would recognize upon the sale or exchange of an interest in a trust (pre-look-through long-term capital gain or loss) minus the amount of look-through capital gain determined under paragraph (b) of this section.

(d) *Special rule for tiered entities.* In determining whether a partnership, S corporation, or trust has gain from collectibles, such partnership, S corporation, or trust shall be treated as owning its proportionate share of the collectibles of any partnership, S corporation, or trust in which it owns an interest either directly or indirectly through a chain of such entities. In determining whether a partnership has *section 1250* capital gain, such partnership shall be treated as owning its proportionate share of the *section 1250* property of any partnership in which it owns an interest, either directly or indirectly through a chain of partnerships.

(e) *Notification requirements.* Reporting rules similar to those that apply to the partners and the partnership under *section 751 (a)* shall apply in the case of sales or exchanges of interests [*32] in a partnership, S corporation, or trust that cause holders of such interests to recognize collectibles gain and in the case of sales or exchanges of interests in a partnership that cause holders of such interests to recognize *section 1250* capital gain. See § 1.751-1 (a) (3).

(f) *Examples.* The following examples illustrate the requirements of this section:

Example 1. Collectibles gain, (i) *A* and *B* are equal partners in a personal service partnership (*PRS*). *B* transfers *B*'s interest in *PRS* to *T* for \$15,000 when *PRS*'s balance sheet (reflecting a cash receipts and disbursements method of accounting) is as follows:

ASSETS		
	Adjusted Basis	Market Value
Cash	\$ 3,000	\$3,000
Loans Owed to Partnership	10,000	10,000
Collectibles	1,000	3,000
Other Capital Assets	6,000	2,000
Capital Assets	7,000	5,000
Unrealized Receivables	0	14,000
Total	\$20,000	\$32,000
LIABILITIES AND CAPITAL		
Liabilities	\$ 2,000	\$2,000
Capital:		
A	9,000	15,000
B	9,000	15,000
Total	\$20,000	\$32,000

(ii) At the time of the transfer, *B* has held the interest in *PRS* for more than one year, and *B*'s basis for the partnership interest is \$10,000 (\$9,000 plus \$1,000, *B*'s share of partnership liabilities). None of the property owned by *PRS* is *section 704 (c)* property. The total amount [*33] realized by *B* is \$16,000, consisting of the cash received, \$15,000, plus \$1,000, *B*'s share of the partnership liabilities assumed by *T*. See *section 752*. *B*'s undivided one-half interest in *PRS* includes a one-half interest in the partnership's unrealized receivables and a one-half interest in the partnership's collectibles.

(iii) If *PRS* were to sell all of its *section 751* property in a fully taxable transaction for cash equal to the fair market value of the assets immediately prior to the transfer of *B*'s partnership interest to *T*, *B* would be allocated \$7,000 of ordinary income from the sale of *PRS*'s unrealized receivables. Therefore, *B* will recognize \$7,000 of ordinary income with respect to the unrealized receivables. The difference between the amount of capital gain or loss that the partner would realize in the absence of *section 751* (\$6,000) and the amount of ordinary income or loss determined under § 1.751-1 (a) (2) (\$7,000) is the partner's capital gain or loss on the sale of the partnership interest under *section 741*. In this case, the transferor has a \$1,000 pre-look-through long-term capital loss.

(iv) If *PRS* were to sell all of its collectibles in a fully taxable transaction for [*34] cash equal to the fair market value of the assets immediately prior to the transfer of *B*'s partnership interest to *T*, *B* would be allocated \$1,000 of gain from the sale of the collectibles. Therefore, *B* will recognize \$1,000 of collectibles gain on account of the collectibles held by *PRS*.

(v) The difference between the transferor's pre-look-through long-term capital gain or loss (-\$1,000) and the look-through capital gain determined under this section (\$1,000) is the transferor's residual long-term capital gain or loss on the sale of the partnership interest. Under these facts, *B* will recognize a \$2,000 residual long-term capital loss on account of the sale or exchange of the interest in *PRS*.

Example 2. Special allocations. Assume the same facts as in *Example 1*, except that under the partnership agreement, all gain from the sale of the collectibles is specially allocated to *B*, and *B* transfers *B*'s interest to *T* for \$16,000. All items of income, gain, loss, or deduction of *PRS*, other than the gain from the collectibles, are divided equally between *A* and *B*. Under these facts, *B*'s amount realized is \$17,000, consisting of the cash received, \$16,000, plus \$1,000, *B*'s share of the partnership [*35] liabilities assumed by *T*. See section 752. *B* will recognize \$7,000 of ordinary income with respect to the unrealized receivables (determined under § 1.751-1 (a) (2)). Accordingly, *B*'s pre-look-through long-term capital gain would be \$0. If *PRS* were to sell all of its collectibles in a fully taxable transaction for cash equal to the fair market value of the assets immediately prior to the transfer of *B*'s partnership interest to *T*, *B* would be allocated \$2,000 of gain from the sale of the collectibles. Therefore, *B* will recognize \$2,000 of collectibles gain on account of the collectibles held by *PRS*. *B* will recognize a \$2,000 residual long-term capital loss on account of the sale of *B*'s interest in *PRS*.

Example 3. Net collectibles loss ignored. Assume the same facts as in *Example 1*, except that the collectibles held by *PRS* have an adjusted basis of \$3,000 and a fair market value of \$1,000, and the other capital assets have an adjusted basis of \$4,000 and a fair market value of \$4,000. (The total adjusted basis and fair market value of the partnership's capital assets are the same as in *Example 1*.) If *PRS* were to sell all of its collectibles in a fully taxable transaction for cash equal [*36] to the fair market value of the assets immediately prior to the transfer of *B*'s partnership interest to *T*, *B* would be allocated \$1,000 of loss from the sale of the collectibles. Because none of the gain from the sale of the interest in *PRS* is attributable to unrealized appreciation in the value of collectibles held by *PRS*, the net loss in collectibles held by *PRS* is not recognized at the time *B* transfers the interest in *PRS*. *B* will recognize \$7,000 of ordinary income (determined under § 1.751-1 (a) (2)) and a \$1,000 long-term capital loss on account of the sale of *B*'s interest in *PRS*.

Example 4. Collectibles gain in an S corporation, (i) A corporation (*X*) has always been an S corporation and is owned by individuals *A*, *B*, and *C*. In 1996, *X* invested in antiques. Subsequent to their purchase, the antiques appreciated in value by \$300. *A* owns one-third of the shares of *X* stock and has held that stock for more than one year. *A*'s adjusted basis in the *X* stock is \$100. If *A* were to sell all of *A*'s *X* stock to *T* for \$150, *A* would realize \$50 of pre-look-through long-term capital gain.

(ii) If *X* were to sell its antiques in a fully taxable transaction for cash equal to the fair market value of [*37] the assets immediately before the transfer to *T*, *A* would be allocated \$100 of gain on account of the sale. Therefore, *A* will recognize \$100 of collectibles gain (look-through capital gain) on account of the collectibles held by *X*.

(iii) The difference between the transferor's pre-look-through long-term capital gain or loss (\$50) and the look-through capital gain determined under this section (\$100) is the transferor's residual long-term capital gain or loss on the sale of the S corporation stock. Under these facts, *A* will recognize \$100 of collectibles gain and a \$50 residual long-term capital loss on account of the sale of *A*'s interest in *X*.

Example 5. Sale or exchange of partnership interest where part of the interest has a short-term holding period, (i) *A*, *B*, and *C* form an equal

partnership (*PRS*). In connection with the formation, *A* contributes \$5,000 in cash and a capital asset with a fair market value of \$5,000 and a basis of \$2,000; *B* contributes \$7,000 in cash and a collectible with a fair market value of \$3,000 and a basis of \$3,000; and *C* contributes \$10,000 in cash. At the time of the contribution, *A* had held the contributed property for two years. Six months later, when *A*'s [*38] basis in *PRS* is \$7,000, *A* transfers *A*'s interest in *PRS* to *T* for \$14,000 at a time when *PRS*'s balance sheet (reflecting a cash receipts and disbursements method of accounting) is as follows:

	ASSETS	
	Adjusted Basis	Market Value
Cash	\$ 22,000	\$22,000
Unrealized Receivables	0	6,000
Capital Asset	2,000	5,000
Collectible	3,000	9,000
Capital Assets	5,000	14,000
Total	\$ 27,000	\$42,000

(ii) Although at the time of the transfer *A* has not held *A*'s interest in *PRS* for more than one year, 50 percent of the fair market value of *A*'s interest in *PRS* was received in exchange for a capital asset with a long-term holding period. Therefore, 50 percent of *A*'s interest in *PRS* has a long-term holding period. See § 1.1223-3 (b) (1).

(iii) If *PRS* were to sell all of its *section 751* property in a fully taxable transaction immediately before *A*'s transfer of the partnership interest, *A* would be allocated \$2,000 of ordinary income. Accordingly, *A* will recognize \$2,000 ordinary income and \$5,000 (\$7,000 - \$2,000) of capital gain on account of the transfer to *T* of *A*'s interest in *PRS*. Fifty percent (\$2,500) of that gain is long-term capital gain and 50 percent (\$2,500) is short-term capital gain. See § 1.1223-3 (c) (1).

(iv) If the collectible [*39] were sold or exchanged in a fully taxable transaction immediately before *A*'s transfer of the partnership interest, *A* would be allocated \$2,000 of gain attributable to the collectible. The gain attributable to the collectible that is allocable to the portion of the transferred interest in *PRS* with a long-term holding period is \$1,000 (50 percent of \$2,000). Accordingly, *A* will recognize \$1,000 of collectibles gain on account of the transfer of *A*'s interest in *PRS*.

(v) The difference between the amount of pre-look-through long-term capital gain or loss (\$2,500) and the look-through capital gain (\$1,000) is the amount of residual long-term capital gain or loss that *A* will recognize on account of the transfer of *A*'s interest in *PRS*. Under these facts, *A* will recognize a residual long-term capital gain of \$1,500 and a short-term capital gain of \$2,500.

(g) *Effective date.* This section applies to transfers of interests in partnerships, S corporations, and trusts that occur on or after September 21, 2000.

Par. 3. *Section 1.741-1* is amended by adding paragraphs (e) and (f) to read as follows:

§ 1.741-1 Recognition and character of gain or loss on sale or exchange.

* * *

(e) For rules relating to the [*40] capital gain or loss recognized when a partner sells or exchanges an interest in a partnership that holds appreciated collectibles or *section 1250* property with section 1250 capital gain, see § 1.1 (h)-1. This paragraph (e) applies to transfers of interests in partnerships that occur on or after September 21, 2000.

(f) For rules relating to dividing the holding period of an interest in a partnership, see § 1.1223-3. This paragraph (f) applies to transfers of partnership interests and distributions of property from a partnership that occur on or after September 21, 2000.

Par. 4 *Section 1.1223-3* is added under the undesignated center heading "General Rules for Determining Capital Gains and Losses" to read as follows:

§ 1.1223-3 Rules relating to the holding periods of partnership interests.

(a) *In general.* A partner shall not have a divided holding period in an interest in a partnership unless-

- (1) The partner acquired portions of an interest at different times; or
- (2) The partner acquired portions of the partnership interest in exchange for property transferred at the same time but resulting in different holding periods (e.g., section 1223).

(b) *Accounting for holding periods of an interest in* [*41] *a partnership* -(1) *General rule.* The portion of a partnership interest to which a holding period relates shall be determined by reference to a fraction, the numerator of which is the fair market value of the portion of the partnership interest received in the transaction to which the holding period relates, and the denominator of which is the fair market value of the entire partnership interest (determined immediately after the transaction).

(2) *Special rule.* For purposes of applying paragraph (b) (1) of this section to determine the holding period of a partnership interest (or portion thereof) that is sold or exchanged (or with respect to which gain or loss is recognized upon a distribution under *section 731*), if a partner makes one or more contributions of cash to the partnership and receives one or more distributions of cash from the partnership during the one-year period ending on the date of the sale or exchange (or distribution with respect to which gain or loss is recognized under section 731), the partner may reduce the cash contributions made during the year by cash distributions received on a last-in-first-out basis, treating all cash distributions as if they were received [*42] immediately before the sale or exchange (or at the time of the distribution with respect to which gain or loss is recognized under section 731).

(3) *Deemed contributions and distributions.* For purposes of paragraphs (b) (1) and (2) of this section, deemed contributions of cash under *section 752 (a)* and deemed distributions of cash under section 752 (b) shall be disregarded to the same extent that such amounts are disregarded under § 1.704-1 (b) (2) (iv) (c).

(4) *Adjustment with respect to contributed section 751 assets.* For purposes of applying paragraph (b) (1) of this section to determine the holding period of a partnership interest (or portion thereof) that is sold or exchanged, if a partner receives a portion of the partnership interest in exchange for property described in section 751 (c) or (d) (section 751 assets) within the one-year period ending on the date of the sale or exchange of all or a portion of the partner's interest in the partnership, and the partner recognizes ordinary income or loss on account of such a section 751 asset in a fully taxable transaction (either as a result of the sale of all or part of the partner's interest in the partnership or the sale by the partnership [*43] of the section 751 asset), the contribution of the section 751 asset during the one-year period shall be disregarded. However, if, in the absence of this paragraph, a partner would not be treated as having held any portion of the interest for more than one year (e.g., because the partner's only contributions to the partnership are contributions of section 751 assets or section 751 assets and cash within the prior one-year period), this adjustment is not available.

(5) *Exception.* The Commissioner may prescribe by guidance published in the Internal Revenue Bulletin (see § 601.601 (d) (2) of this chapter) a rule disregarding certain cash contributions (including contributions of a *de minimis* amount of cash) in applying paragraph (b) (1) of this section to determine the holding period of a partnership interest (or portion thereof) that is sold or exchanged.

(c) *Sale or exchange of all or a portion of an interest in a partnership* -(1) *Sale or exchange of entire interest in a partnership.* If a partner sells or exchanges the partner's entire interest in a partnership, any capital gain or loss recognized shall be divided between long-term and short-term capital gain or loss in the same proportions [*44] as the holding period of the interest in the partnership is divided between the portion of the interest held for more than one year and the portion of the interest held for one year or less.

(2) *Sale or exchange of a portion of an interest in a partnership* -(i) *Certain publicly traded partnerships.* A selling partner in a publicly traded partnership (as defined under section 7704 (b)) may use the actual holding period of the portion of a partnership interest transferred if-

- (A) The ownership interest is divided into identifiable units with ascertainable holding periods;
- (B) The selling partner can identify the portion of the partnership interest transferred; and
- (C) The selling partner elects to use the identification method for all sales or exchanges of interests in the partnership after September 21, 2000. The selling partner makes the election referred to in this paragraph (c) (2) (i) (C) by using the actual holding period of the portion of the partner's interest in the partnership first transferred after September 21, 2000, in reporting the transaction for federal income tax purposes.

(ii) *Other partnerships.* If a partner has a divided holding period in a partnership interest, and paragraph [*45] (c) (2) (i) of this section does not apply, then the holding period of the transferred interest shall be divided between long-term and short-term capital gain or loss in the same proportions as the long-term and short-term capital gain or loss that the transferor partner would realize if the entire interest in the partnership were transferred in a fully taxable transaction immediately before the actual transfer.

(d) *Distributions*-(1) *In general*. Except as provided in paragraph (b) (2) of this section, a partner's holding period in a partnership interest is not affected by distributions from the partnership.

(2) *Character of capital gain or loss recognized as a result of a distribution from a partnership*. If a partner is required to recognize capital gain or loss as a result of a distribution from a partnership, then the capital gain or loss recognized shall be divided between long-term and short-term capital gain or loss in the same proportions as the long-term and short-term capital gain or loss that the distributee partner would realize if such partner's entire interest in the partnership were transferred in a fully taxable transaction immediately before the distribution.

(e) *Section 751 (c) [*46] assets*. For purposes of this section, properties and potential gain treated as unrealized receivables under section 751 (c) shall be treated as separate assets that are not capital assets as defined in section 1221 or property described in section 1231.

(f) *Examples*. The provisions of this section are illustrated by the following examples:

Example 1. Division of holding period-contribution of money and a capital asset. (i) A contributes \$5,000 of cash and a nondepreciable capital asset A has held for two years to a partnership (PRS) for a 50 percent interest in PRS. A's basis in the capital asset is \$5,000, and the fair market value of the asset is \$10,000. After the exchange, A's basis in A's interest in PRS is \$10,000, and the fair market value of the interest is \$15,000. A received one-third of the interest in PRS for a cash payment of \$5,000 (\$5,000/\$15,000). Therefore, A's holding period in one-third of the interest received (attributable to the contribution of money to the partnership) begins on the day after the contribution. A received two-thirds of the interest in PRS in exchange for the capital asset (\$10,000/\$15,000). Accordingly, pursuant to section 1223 (1), A has a two-year [*47] holding period in two-thirds of the interest received in PRS.

(ii) Six months later, when A's basis in PRS is \$12,000 (due to a \$2,000 allocation of partnership income to A), A sells the interest in PRS for \$17,000. Assuming PRS holds no inventory or unrealized receivables (as defined under section 751 (c)) and no collectibles or section 1250 property, A will realize \$5,000 of capital gain. As determined above, one-third of A's interest in PRS has a holding period of one year or less, and two-thirds of A's interest in PRS has a holding period equal to two years and six months. Therefore, one-third of the capital gain will be short-term capital gain, and two-thirds of the capital gain will be long-term capital gain.

Example 2. Division of holding period-contribution of section 751 asset and a capital asset. A contributes inventory with a basis of \$2,000 and a fair market value of \$6,000 and a capital asset which A has held for more than one year with a basis of \$4,000 and a fair market value of \$6,000, and B contributes cash of \$ 12,000 to form a partnership (AB). As a result of the contribution, one-half of A's interest in AB is treated as having been held for more than one year under [*48] section 1223 (1). Six months later, A transfers one-half of A's interest in AB to C for \$6,000, realizing a gain of \$3,000. If AB were to sell all of its section 751 property in a fully taxable transaction immediately before A's transfer of the partnership interest, A would be allocated \$4,000 of ordinary income on account of the inventory. Accordingly, A will recognize \$2,000 of ordinary income and \$1,000 of capital gain (\$3,000 - \$2,000) on account of the transfer to C.

Because A recognizes ordinary income on account of the inventory that was contributed to AB within the one year period ending on the date of the sale, the inventory will be disregarded in determining the holding period of A's interest in AB. All of the capital gain will be long-term.

Example 3. Netting of cash contributions and distributions. (i) On January 1, 2000, A holds a 50 percent interest in the capital and profits of a partnership (PS). The value of A's PS interest is \$900, and A's holding period in the entire interest is long-term. On January 2, 2000, when the value of A's PS interest is still \$900, A contributes \$100 to PS. On June 1, 2000, A receives a distribution of \$40 cash from the partnership. On September 1, 2000, when the value of A's interest in PS is \$1,350, A contributes an additional \$230 cash to PS, and on October 1, 2000, A receives another \$40 cash distribution from PS. A sells A's entire partnership interest on November 1, 2000, for \$1,600. A's adjusted basis in the PS interest at the time of the sale is \$1,000.

(ii) For purposes of netting cash contributions and distributions in determining the holding period of A's interest in PS, A is treated as having received a distribution of \$80 on November 1, 2000. Applying that distribution on a last-in-first-out basis to reduce prior contributions during the year, the contribution made on September 1, 2000, is reduced to \$150 (\$230 - \$80). The holding period then is determined as follows: Immediately after the contribution of \$100 on January 2, 2000, A's holding period in A's PS interest is 90 percent long-term ($\$900/(\$900 + \$100)$) and 10 percent short-term ($\$100/(\$900 + \$100)$). The contribution of \$150 on September 1, 2000, causes 10 percent of A's partnership interest ($\$150/(\$1,350 + \$150)$) to have a short-term holding period. Accordingly, immediately after the contribution on September 1, 2000, A's holding period in [*50] A's PS interest is 81 percent long-term ($.90 \times .90$) and 19 percent short-term ($(.10 \times .90) + .10$). Accordingly, \$486 ($\$600 \times .81$) of the gain from A's sale of the PS interest is long-term capital gain, and \$114 ($\$600 \times .19$) is short-term capital gain.

Example 4. Division of holding period when capital account is increased by contribution. A, B, C, and D are equal partners in a partnership (PRS), and the fair market value of a 25 percent interest in PRS is \$100. A, B, C, and D each contribute an additional \$100 to partnership capital, thereby increasing the fair market value of each partner's interest to \$200. As a result of the contribution, each partner has a new holding period in the portion of the partner's interest in PRS that is attributable to the contribution. That portion equals 50 percent ($\$100/\200) of each partner's interest in PRS.

Example 5. Sale or exchange of a portion of an interest in a partnership. (i) A, B, and C form an equal partnership (PRS). In connection with the formation, A contributes \$5,000 in cash and a capital asset (capital asset 1) with a fair market value of \$5,000 and a basis of \$2,000; B contributes \$7,000 in cash and a capital asset (capital asset [*51] 2) with a fair market value of \$3,000 and a basis of \$3,000; and C contributes \$10,000 in cash. At the time of the contribution, A had held the contributed property for two years. Six months later, when A's basis in PRS is \$7,000, A transfers one-half of A's interest in PRS to T for \$7,000 at a time when PRS's balance sheet (reflecting a cash receipts and disbursements method of accounting) is as follows:

	ASSETS	
	Adjusted Basis	Market Value
Cash	\$ 22,000	\$22,000
Unrealized Receivables	0	6,000
Capital Asset 1	2,000	5,000
Capital Asset 2	3,000	9,000
Capital Assets	5,000	14,000
Total	\$ 27,000	\$42,000

(ii) Although at the time of the transfer A has not held A's interest in PRS for more than one year, 50 percent of the fair market value of A's interest in PRS was received in exchange for a capital asset with a long-term holding period. Therefore, 50 percent of A's interest in PRS has a long-term holding period.

(iii) If PRS were to sell all of its section 751 property in a fully taxable transaction immediately before A's transfer of the partnership interest, A would be allocated \$2,000 of ordinary income. One-half of that amount (\$1,000) is attributable to the portion of A's interest in PRS transferred to T. Accordingly, [*52] A will recognize \$1,000 ordinary income and \$2,500 (\$3,500 - \$1,000) of capital gain on account of the transfer to T of one-half of A's interest in PRS. Fifty percent (\$1,250) of that gain is long-term capital gain and 50 percent (\$1,250) is short-term capital gain.

Example 6. Sale of units of interests in a partnership. A publicly traded partnership (PRS) has ownership interests that are segregated into identifiable units of interest. A owns 10 limited partnership units in PRS for which A paid \$10,000 on January 1, 1999. On August 1, 2000, A purchases five additional units for \$10,000. At the time of purchase, the fair market value of each unit has increased to \$2,000. A's holding period for one-third (\$10,000/\$30,000) of the interest in PRS begins on the day after the purchase of the five additional units. Less than one year later, A sells five units of ownership in PRS for \$11,000. At the time, A's basis in the 15 units of PRS is \$20,000, and A's capital gain on the sale of 5 units is \$4,333 (amount realized of \$11,000 - one-third of the adjusted basis or \$6,667). For purposes of determining the holding period, A can designate the specific units of PRS sold. If A properly identifies [*53] the five units sold as five of the ten units for which A has a long-term holding period and elects to use the identification method for all subsequent sales or exchanges of interests in the partnership by using the actual holding period in reporting the transaction on A's federal income tax return, the capital gain realized will be long-term capital gain.

Example 7. Disproportionate distribution. In 1997, A and B each contribute cash of \$50,000 to form and become equal partners in a partnership (PRS). More than one year later, A receives a distribution worth \$22,000 from PRS, which reduces A's interest in PRS to 36 percent. After the distribution, B owns 64 percent of PRS. The holding periods of A and B in their interests in PRS are not affected by the distribution.

Example 8. Gain or loss as a result of a distribution-(i) On January 1, 1996, A contributes property with a basis of \$10 and a fair market value of \$10,000 in exchange for an interest in a partnership (ABC). On September 30, 2000, when A's interest in ABC is worth \$12,000 (and the basis of A's partnership interest is still \$10), A contributes \$12,000 cash in exchange for an additional interest in ABC. A is allocated a loss [*54] equal to \$10,000 by ABC for the taxable year ending December 31, 2000, thereby

reducing the basis of A's partnership interest to \$2,010. On February 1, 2001, ABC makes a cash distribution to A of \$10,000. ABC holds no inventory or unrealized receivables. (Assume that A is allocated no gain or loss for the taxable year ending December 31, 2001, so that the basis of A's partnership interest does not increase or decrease as a result of such allocations.)

(ii) The netting rule contained in paragraph (b) (2) of this section provides that, in determining the holding period of A's interest in ABC, the cash contribution made on September 30, 2000, must be reduced by the distribution made on February 1, 2001. Accordingly, for purposes of determining the holding period of A's interest in ABC, A is treated as having made a cash contribution of \$2,000 (\$12,000 - \$10,000) to ABC on September 30, 2000. A's holding period in one-seventh of A's interest in ABC (\$2,000 cash contributed over the \$14,000 value of the entire interest (determined as if only \$2,000 were contributed rather than \$12,000)) begins on the day after the cash contribution. A recognizes \$7,990 of capital gain as a result of the distribution. [*55] See section 731 (a) (1). One-seventh of the capital gain recognized as a result of the distribution is short-term capital gain, and six-sevenths of the capital gain is long-term capital gain. After the distribution, A's basis in the interest in PRS is \$0, and the holding period for the interest in PRS continues to be divided in the same proportions as before the distribution.

(g) *Effective date.* This section applies to transfers of partnership interests and distributions of property from a partnership that occur on or after September 21, 2000.

PART 602-OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 5. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 6. In § 602.101, paragraph (b) is amended by adding an entry in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers.

* * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
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1.1 (h)-1 (e)
* * *

1545-1654

Robert E. Wenzel,

Deputy Commissioner of Internal Revenue.

Approved August 29, 2000.

Jonathan Talisman,

Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on September 20, 2000, 8:45 a.m., and published in the [*56] issue of the Federal Register for September 21, 2000, 65 *F.R.* 57092)