

Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 805.—General Deductions

A revenue procedure to provide a safe harbor under which companies taxable under Subchapter L do not have to include any portion of the increase for the taxable year in policy cash values of life insurance contracts described in section 264(f)(4)(A) (“ICOLI Contracts”) for purposes of applying the insurance company proration rules in sections 807(a)(2), 807(b)(1), 805(a)(4), 812, or 832(b)(5). See Rev. Proc. 2007-61, page 747.

Section 807.—Rules for Certain Reserves

A revenue procedure to provide a safe harbor under which companies taxable under Subchapter L do not have to include any portion of the increase for the taxable year in policy cash values of life insurance contracts described in section 264(f)(4)(A) (“ICOLI Contracts”) for purposes of applying the insurance company proration rules in sections 807(a)(2), 807(b)(1), 805(a)(4), 812, or 832(b)(5). See Rev. Proc. 2007-61, page 747.

Section 812.—Definition of Company’s Share and Policyholders’ Share

A revenue procedure to provide a safe harbor under which companies taxable under Subchapter L do not have to include any portion of the increase for the taxable year in policy cash values of life insurance contracts described in section 264(f)(4)(A) (“ICOLI Contracts”) for purposes of applying the insurance company proration rules in sections 807(a)(2), 807(b)(1), 805(a)(4), 812, or 832(b)(5). See Rev. Proc. 2007-61, page 747.

Section 832.—Insurance Company Taxable Income

A revenue procedure to provide a safe harbor under which companies taxable under Subchapter L do not have to include any portion of the increase for the taxable year in policy cash values of life insurance contracts described in section 264(f)(4)(A) (“ICOLI Contracts”) for purposes of applying the insurance company proration rules in sections 807(a)(2), 807(b)(1), 805(a)(4), 812, or 832(b)(5). See Rev. Proc. 2007-61, page 747.

Section 1045.—Rollover of Gain From Qualified Small Business Stock to Another Qualified Small Business Stock

26 CFR 1.1045-1: Application to partnerships.

T.D. 9353

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 1 and 602

Section 1045 Application to Partnerships

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the application of section 1045 of the Internal Revenue Code (Code) to partnerships and their partners. These regulations provide rules regarding the deferral of gain on a partnership’s sale of qualified small business stock (QSB stock) and a partner’s sale of QSB stock distributed by a partnership. These regulations also provide rules for a taxpayer (other than a C corporation) who sells QSB stock and purchases replacement QSB stock through a partnership. The regulations affect partnerships that invest in QSB stock and their partners.

DATES: *Effective Date:* These regulations are effective August 14, 2007.

Applicability Dates: For dates of applicability of these regulations, see §1.1045-1(j).

FOR FURTHER INFORMATION CONTACT: Jian H. Grant at (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 the Office of

Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-1893. Responses to these collections of information are mandatory and are required to obtain a benefit. The collections of information in these final regulations are in §1.1045-1(b)(3)(ii)(C), (b)(5)(ii), and (c)(4)(ii). The information collected in §1.1045-1(b)(5)(ii) is required to ensure that gain from the sale of QSB stock by a partnership is reported correctly. The information collected in §1.1045-1(b)(3)(ii)(C) and (c)(4)(ii) will be used by the partnership and the partner to make the basis adjustments upon the sale of QSB stock and the purchase of replacement QSB stock when necessary. The likely respondents are businesses or other for-profit institutions and small businesses or organizations.

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

Estimated total annual reporting burden: 1,500 hours.

The estimated annual burden per respondent varies from 45 to 75 minutes, depending on individual circumstances, with an estimated average of 1 hour.

Estimated number of respondents: 1,500.

Estimated annual frequency of responses: On occasion.

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, SE:W:CAR:MP:T:T:SP, 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 these collections 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 return information are confidential, as required by 26 U.S.C. 6103.

Background

This document amends 26 CFR Part 1 under section 1045 of the Code by adding §1.1045-1 regarding the application of section 1045 to partnerships and their partners.

Section 1045 permits a non-corporate taxpayer that holds QSB stock for more than six months and sells it after August 5, 1997, to elect to defer recognizing gain (other than gain treated as ordinary income) on the sale. To qualify for such deferral, the taxpayer must purchase QSB stock (replacement QSB stock) within a 60-day period beginning on the date of the sale of the QSB stock. Any gain not recognized reduces the cost basis of the replacement QSB stock. The taxpayer recognizes gain to the extent the amount realized on the sale of the QSB stock exceeds the cost basis of the replacement QSB stock. The benefits of section 1045 with respect to a sale of QSB stock by a partnership flow through to a non-corporate partner that held an interest in the partnership at all times the partnership held the QSB stock. See section 1045(b)(5) and the legislative history accompanying section 6005(f)(2) of the Internal Revenue Service Restructuring and Reform Act of 1998, Public Law 105-206 (112 Stat. 6005(f)(2)), July 22, 1998. In response to inquiries, the IRS issued Rev. Proc. 98-48, 1998-2 C.B. 367, which provides procedures for taxpayers (including passthrough entities and individuals holding interests in a passthrough entity) to elect to apply section 1045. Since Rev. Proc. 98-48 was published, the IRS and the Treasury Department received further inquiries regarding the application of section 1045 to partnerships and their partners. See §601.601(d)(2)(ii)(b) of this chapter.

On July 15, 2004, in response to those inquiries, a notice of proposed rule-making and a notice of public hearing (REG-150562-03, 2004-2 C.B. 175) were published in the **Federal Register** (69 FR 42370) regarding the application of section 1045 to partnerships and their partners. No one requested to speak at the public hearing. Accordingly, the public hearing scheduled for November 9, 2004, was cancelled in the **Federal Register** (69 FR 62631) on October 27, 2004. Comments responding to the proposed regulations were received. After consid-

eration of the comments, the proposed regulations are adopted as revised by this Treasury decision.

Summary of Comments and Explanation of Revisions

1. *QSB Stock — Replacement QSB Stock Requirement*

The proposed regulations provided that the term “QSB stock” had the same meaning given such term by section 1202(c) and did not include an interest in a partnership that held QSB stock. Thus, under the proposed regulations, an investment in a partnership that held QSB stock was not treated as an investment in QSB stock. Consequently, a partner that sold an interest in a partnership that held QSB stock was not treated as selling QSB stock, and could not elect to apply section 1045 with respect to gain realized on the sale of the partnership interest. Similarly, under the proposed regulations, a partner that made a section 1045 election with respect to QSB stock sold by the partnership could not treat as replacement QSB stock an interest in a second partnership that held QSB stock.

Commentators agreed that an interest in a partnership that owns QSB stock should not be treated as an investment in QSB stock. Some commentators, however, argued that the final regulations should permit a partner that makes a section 1045 election with respect to QSB stock sold by one partnership to satisfy the replacement QSB stock requirement of section 1045 by holding an interest in a partnership, which acquires QSB stock within the statutory period. Commentators believed that the suggested rule is consistent with the intent of Congress to encourage investments in QSB stock.

The final regulations adopt this comment. A taxpayer (other than a C corporation) that sells QSB stock and elects to apply section 1045 may satisfy the replacement QSB stock requirement with QSB stock that is purchased within the statutory period by a partnership in which the taxpayer is a partner on the date the QSB stock is purchased (purchasing partnership). In addition, the final regulations provide that an eligible partner of a partnership that sells QSB stock (selling partnership) and elects to apply section 1045 may satisfy

the replacement QSB stock requirement with QSB stock purchased by a purchasing partnership during the statutory period. The IRS and the Treasury Department believe that these rules are appropriate because they are consistent with the underlying continuous economic interest requirement of section 1045. Although the final regulations permit the replacement QSB stock requirement to be satisfied in this manner, for the reasons stated, a partner that sells its interest in the purchasing partnership is not treated as selling replacement QSB stock.

The final regulations contain rules for calculating a partner’s distributive share of partnership gain that is not recognized as a result of an election under section 1045 by the partner. These rules are necessary for determining how much gain a partner can defer upon a sale of QSB stock under section 1045. These rules address instances in which the eligible partner continues to defer gain under section 1045 from a prior sale or sales of QSB stock.

2. *Basis Adjustments*

The proposed regulations provided rules regarding adjustments to an eligible partner’s basis in a partnership interest and a partnership’s basis in replacement QSB stock. One rule required a partnership to make a basis adjustment to the partnership’s replacement QSB stock by the amount of gain from the partnership’s sale of QSB stock that is deferred by an eligible partner, the effect of which is determined under the principles of §1.743-1(g), (h), and (j). Under this rule, the basis adjustments constitute an adjustment to the basis of the partnership’s replacement QSB stock with respect to that eligible partner only. To allow the partnership to make the appropriate basis adjustments, the proposed regulations required any partner that must recognize all or a part of the partner’s distributive share of partnership section 1045 gain to notify the partnership of the amount of the partnership section 1045 gain that was recognized.

One commentator argued that many partnerships that invest in QSB stock are thinly staffed, and that they would incur additional administrative expenses to comply with the notification and basis adjustment requirements. Therefore, the commentator suggested that the partner

make the basis adjustments with respect to the partnership's replacement QSB stock, unless the partnership makes an election to make the basis adjustments.

The IRS and the Treasury Department believe that, if the partnership makes an election under section 1045 and purchases replacement QSB stock, the partnership is the proper party to make the appropriate basis adjustments with respect to that stock. Accordingly, this comment is not adopted. As noted below, a partnership is not required to maintain these basis adjustments for eligible partners that separately make the election under section 1045. The final regulations also clarify that if a partnership makes an election under section 1045, the partnership must attach a statement to the partnership return for the taxable year in which the partnership purchases replacement QSB stock setting forth the computation of the adjustment, the replacement QSB stock to which the adjustment has been made, the date(s) on which such stock was acquired by the partnership, and each partner's distributive share of deferred partnership section 1045 gain.

If a taxpayer or an eligible partner makes an election under section 1045 and treats its interest in QSB stock purchased by a purchasing partnership as its replacement QSB stock, the final regulations provide specific rules for the determination of the partner's basis in the replacement QSB stock and interest in the purchasing partnership. In these cases, the partner's adjusted basis in the partnership interest is reduced by the partner's gain that is deferred under section 1045, and the electing partner must reduce its share of the partnership's adjusted basis of the replacement QSB stock by the amount of gain deferred. When the basis reduction results from a partner-level election, the final regulations require the partner, rather than the partnership, to retain records setting forth the computation of this basis adjustment, the replacement QSB stock to which the adjustment has been made, and the date(s) on which such stock was acquired by the purchasing partnership.

3. *Gain Recognition Upon Certain Distributions*

The final regulations provide rules requiring a partner to recognize gain upon a

distribution of replacement QSB stock to another partner that reduces the partner's share of the replacement QSB stock held by a partnership. The amount of gain that the partner must recognize is determined based on the amount of gain that the partner would have recognized upon a sale of the distributed replacement QSB stock for its fair market value on the date of the distribution (not to exceed the amount of gain previously deferred by the partner with respect to the distributed replacement QSB stock). Any gain recognized by a partner whose interest is reduced must be taken into account in determining the adjusted basis of the partner's interest in the partnership and also taken into account in determining the partnership's adjusted basis in the QSB stock distributed to another partner under §1.1045-1(e)(4). These rules apply in the case of a partner election or a partnership election under section 1045.

4. *Nonrecognition Limitation*

The proposed regulations provided that the amount of gain that an eligible partner may defer under section 1045 may not exceed: (A) the partner's smallest percentage interest in the partnership's income, gain, or loss with respect to the QSB stock that was sold, multiplied by (B) the partnership's realized gain from the sale of such stock. This nonrecognition rule follows section 1202(g)(2) and (3) by ensuring that the partner can defer recognition of only the gain that relates to the partner's continuous economic interest in the QSB stock that was sold.

Commentators agreed with the underlying "continuous ownership" requirement in the proposed regulations, but raised concerns that the nonrecognition limitation rule may be difficult to administer when a partnership does not have a simple "pro rata" partnership arrangement. One commentator suggested that the nonrecognition limitation rule only apply in certain situations.

The IRS and the Treasury Department continue to believe that a nonrecognition limitation rule is consistent with section 1045 and the underlying continuous economic interest requirement in section 1202(g)(2) and (3). The continuous economic interest requirement as applied under section 1202(c)(1)(B) requires that

QSB stock must be acquired by the taxpayer at its original issuance in exchange for money or other property or as compensation for services provided to such corporation. Taxpayers that invest through a partnership acquire the requisite interest for purposes of the continuous economic interest requirement by an investment of capital in the partnership. Accordingly, to address the commentator's concerns, the nonrecognition rule has been modified to provide that the amount of gain that an eligible partner may defer under section 1045 may not exceed: (A) the partner's smallest percentage interest in partnership capital from the time the QSB stock is acquired until the time the QSB stock is sold, multiplied by (B) the partnership's realized gain from the sale of such stock. The IRS and the Treasury Department believe that this nonrecognition rule in the final regulations will be easier to administer, is consistent with each partner's economic interest in the partnership, and will not inappropriately limit the amount of gain that can be deferred.

5. *Opt Out of Partnership Election by Partner*

The proposed regulations allowed an eligible partner to make a section 1045 election with respect to all or part of the partner's share of gain from the partnership's sale of QSB stock only if the partnership did not make a section 1045 election, or the partnership did make a section 1045 election, but failed to purchase any (or enough) replacement QSB stock within the statutory time period. If a partnership elected to apply section 1045 and purchased replacement QSB stock, all eligible partners of the partnership were required to defer their distributive shares of the partnership section 1045 gain. One commentator suggested that an eligible partner should be allowed to opt out of a partnership section 1045 election and either purchase separate replacement QSB stock directly, and elect to apply section 1045 at the partner level, or recognize the partner's distributive share of the partnership section 1045 gain. The IRS and the Treasury Department believe that allowing a partner to opt out of a partnership section 1045 election is consistent with providing the intended and desired flexibility for investments in QSB stock. Accordingly, this comment is

adopted. The final regulations provide that a partner that elects out of a partnership's section 1045 election must notify the partnership in writing. If an eligible partner opts out of a partnership section 1045 election, such action does not constitute a revocation of the partnership section 1045 election and the partnership section 1045 election continues to apply to the other partners.

The final regulations do not impose a deadline for when a partner must notify the partnership that the partner is opting out of a partnership section 1045 election. The IRS and the Treasury Department believe partnerships are responsible for obtaining the required information to report gain properly, and that the partnership agreement should require that partners supply this notice to the partnership in a timely manner.

6. Tiered-partnership Rules

Under the proposed regulations, only an eligible partner was entitled to defer gain under section 1045. The proposed regulations provided special rules for determining whether a partner was an eligible partner if a partnership (upper-tier partnership) held an interest in a partnership (lower-tier partnership) that held QSB stock. The proposed regulations disregarded the upper-tier partnership's ownership of the lower-tier partnership and treated each partner of the upper-tier partnership as owning an interest in the lower-tier partnership directly. The preamble to the proposed regulations explained that, although this rule provided a simple approach, it limited the availability of section 1045 in situations involving tiered partnerships. The IRS and the Treasury Department requested comments specifically on the application of section 1045 in tiered-partnership situations.

Commentators suggested that an upper-tier partnership should be an "eligible partner" of a lower-tier partnership and allowed to make an election to defer gain under section 1045 with respect to the distributive share of the gain from the lower-tier partnership's sale of QSB stock. After careful consideration, the IRS and the Treasury Department have concluded that treating an upper-tier partnership as an "eligible partner" of a lower-tier partnership would create an unacceptable administrative burden and increased com-

plexity to the rules. Therefore, the final regulations retain the rule in the proposed regulations relating to tiered-partnership structures. The final regulations, however, clarify that the rule does not preclude a partner in an upper-tier partnership from treating its interest in QSB stock that was purchased by either the upper-tier partnership or a lower-tier partnership as replacement QSB stock. The final regulations contain an example illustrating this rule.

7. Disregarded Entity Rules

One commentator suggested that the final regulations set forth rules that are specific to disregarded entities. It has been determined that this suggestion is beyond the scope of the regulations and, therefore, is not included in the final regulations.

8. Election Procedures and Reporting Rules

The proposed regulations provided that a partnership making a section 1045 election must do so on the partnership's timely filed return (including extensions) for the taxable year during which the partnership sells the QSB stock. The proposed regulations also provided that a partner making an election under section 1045 with respect to its distributive share of gain on the partnership's sale of QSB stock must do so on the partner's timely filed Federal income tax return (including extensions) for the taxable year in which such gain is taken into account. The final regulations retain these rules. However, in both cases, the proposed regulations stated that the electing partnership or partner also must follow the procedures of Rev. Proc. 98-48. In contrast, the final regulations provide that a partnership making an election under section 1045 or a partner making an election under section 1045 must do so in accordance with the applicable forms and instructions. It is anticipated that the applicable forms and instructions will be revised to take into account the rules in the final regulations.

Effective/Applicability Date

The final regulations apply to sales of QSB stock on or after August 14, 2007.

Effect on Other Documents

Rev. Proc. 98-48, 1998-2 C.B. 367, is modified to include the following sentence at the end of the PURPOSE section: "This revenue procedure does not apply in situations described in §1.1045-1 of the Income Tax regulations." See §601.601(d)(2)(ii)(b) of this chapter.

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 economic impact on a substantial number of small entities. This certification is based upon the fact that QSB stock is not held by a substantial number of small entities and that the time required to make the election is estimated to average 1 hour. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking that preceded 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 author of these regulations is Jian H. Grant, Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and the Treasury Department 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:

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:
Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.1045-1 is added to read as follows:

§1.1045-1 Application to partnerships.

(a) *Overview of section.* A partnership that holds qualified small business stock (QSB stock) (as defined in paragraph (g)(1) of this section) for more than 6 months, sells such QSB stock, and purchases replacement QSB stock (as defined in paragraph (g)(2) of this section) may elect to apply section 1045. An eligible partner (as defined in paragraph (g)(3) of this section) of a partnership that sells QSB stock, may elect to apply section 1045 if the eligible partner purchases replacement QSB stock directly or through a purchasing partnership (as defined in paragraph (c)(1)(i) of this section). A taxpayer (other than a C corporation) that holds QSB stock for more than 6 months, sells such QSB stock and purchases replacement QSB stock through a purchasing partnership may elect to apply section 1045. A section 1045 election is revocable only with the prior written consent of the Commissioner. To obtain the Commissioner's prior written consent, the person who made the section 1045 election must submit a request for a private letter ruling. (For further guidance, see Rev. Proc. 2007-1, 2007-1 C.B. 1 (or any applicable successor) and §601.601(d)(2)(ii)(b) of this chapter.) Paragraph (b) of this section provides rules for partnerships that elect to apply section 1045. Paragraph (c) of this section provides rules for certain taxpayers other than C corporations and for eligible partners that elect to apply section 1045. Paragraph (d) of this section provides a limitation on the amount of gain that an eligible partner does not recognize under section 1045. Paragraph (e) of this section provides rules for partnership distributions of QSB stock to an eligible partner. Paragraph (f) of this section provides rules for contributions of QSB stock or replacement QSB stock to a partnership. Paragraph (g) of this section provides definitions of certain terms used in section 1045 and this section. Paragraph (h) of this section provides reporting rules for partnerships and partners that elect to apply section 1045. Paragraph (i) of this section provides examples illustrating the provisions of this section. Paragraph (j) of this section contains the effective date.

(b) *Partnership election*—(1) *Partnership purchase of replacement QSB stock.* A partnership that holds QSB stock for

more than 6 months, sells such QSB stock, and purchases replacement QSB stock may elect in accordance with paragraph (h) of this section to apply section 1045. If the partnership elects to apply section 1045, then, subject to the provisions of paragraphs (b)(4) and (d) of this section, each eligible partner shall not recognize its distributive share of any partnership section 1045 gain (as determined under paragraph (b)(2) of this section). For this purpose, partnership section 1045 gain equals the partnership's gain from the sale of the QSB stock reduced by the greater of—

(i) The amount of the gain from the sale of the QSB stock that is treated as ordinary income; or

(ii) The excess of the amount realized by the partnership on the sale over the total cost of all replacement QSB stock purchased by the partnership (excluding the cost of any replacement QSB stock purchased by the partnership that is otherwise taken into account under section 1045).

(2) *Partner's distributive share of partnership section 1045 gain.* A partner's distributive share of partnership section 1045 gain shall be in the same proportion as the partner's distributive share of the partnership's gain from the sale of the QSB stock. For this purpose, the partnership's gain from the sale of QSB stock and the partner's distributive share of that gain are determined without regard to basis adjustments under section 743(b) and paragraph (b)(3)(ii) of this section.

(3) *Basis adjustments*—(i) *Partner's interest in a partnership.* The adjusted basis of an eligible partner's interest in a partnership shall not be increased under section 705(a)(1) by gain from a partnership's sale of QSB stock that is not recognized by the partner as the result of a partnership election under paragraph (b)(1) of this section.

(ii) *Partnership's replacement QSB stock*—(A) *Rule.* The basis of a partnership's replacement QSB stock is reduced (in the order acquired) by the amount of gain from the partnership's sale of QSB stock that is not recognized by an eligible partner as a result of the partnership's election under section 1045. The basis adjustment with respect to any amount described in this paragraph (b)(3)(ii) constitutes an adjustment to the basis of the partnership's replacement QSB stock with respect to that partner only. The effect of

such a basis adjustment is determined under the principles of §1.743-1(g), (h), and (j) except as modified in this paragraph (b)(3)(ii)(A). If a partnership sells QSB stock with respect to which a basis adjustment has been made under this paragraph (b)(3)(ii), and the partnership makes an election under paragraph (b)(1) of this section with respect to the sale and purchases replacement QSB stock, the basis adjustment shall carry over to the replacement QSB stock except to the extent otherwise provided in this paragraph (b)(3)(ii). The basis adjustment that carries over to the replacement QSB stock shall be reduced (but not below zero) by the eligible partner's distributive share of the excess, if any, of the greater of the amount determined under paragraph (b)(1)(i) or (ii) of this section from the sale of the QSB stock, over the partnership's gain from the sale of the QSB stock (determined without regard to basis adjustments under section 743 or paragraph (b)(3)(ii) of this section). The excess amount that reduces the basis adjustment shall be accounted for as gain in accordance with §1.743-1(j)(3). See *Example 5* of paragraph (i) of this section. For purposes of this paragraph (b)(3)(ii), a partnership must presume that a partner did not recognize that partner's distributive share of the partnership section 1045 gain as a result of the partnership's section 1045 election unless the partner notifies the partnership to the contrary as described in paragraph (b)(5)(ii) of this section. However, if a partnership knows that a particular partner is classified, for Federal tax purposes, as a C corporation, then the partnership may presume that the partner did not defer recognition of its distributive share of the partnership section 1045 gain, even in the absence of a notification by the partner. If a partnership makes an election under section 1045, but an eligible partner opts out of the election under paragraph (b)(4) of this section and provides to the partnership the notification required under paragraph (b)(5)(ii) of this section, no basis adjustments under this paragraph (b)(3)(ii) are required with respect to that partner as a result of the section 1045 election by the partnership.

(B) *Tiered-partnership rule.* If a partnership (upper-tier partnership) holds an interest in another partnership (lower-tier partnership) that makes an election under section 1045, the portion of the lower-tier

partnership's basis adjustment as provided in paragraph (b)(3)(ii)(A) of this section in the replacement QSB stock must be segregated and allocated to the upper-tier partnership and any eligible partner as defined in paragraph (g)(3)(iii) of this section. Similarly, that portion of the basis of the upper-tier partnership's interest in the lower-tier partnership attributable to the basis adjustment as provided in paragraph (b)(3)(ii)(A) of this section in the lower-tier partnership's replacement QSB stock must be segregated and allocated solely to any eligible partner as defined in paragraph (g)(2)(iii) of this section.

(C) *Statement of adjustments.* A partnership that must adjust the basis of replacement QSB stock under this paragraph (b) must attach a statement to the partnership return for the taxable year in which the partnership purchases replacement QSB stock setting forth the computation of the adjustment, the replacement QSB stock to which the adjustment has been made, the date(s) on which such QSB stock was acquired by the partnership, and the amount of the adjustment that is allocated to each partner.

(4) *Eligible partners may opt out of partnership's section 1045 election.* An eligible partner may opt out of the partnership's section 1045 election with respect to QSB stock either by recognizing the partner's distributive share of the partnership section 1045 gain, or by making a partner section 1045 election under paragraph (c) of this section with respect to the partner's distributive share of the partnership section 1045 gain. See paragraph (b)(5)(ii) of this section for applicable notification requirements. Opting out of a partnership's section 1045 election under this paragraph (b)(4) does not constitute a revocation of the partnership's election, and such election shall continue to apply to other partners of the partnership.

(5) *Notice requirements—(i) Partnership notification to partners.* A partnership that makes an election under paragraph (b)(1) of this section must notify all of its partners of the election and the purchase of replacement QSB stock, in accordance with the applicable forms and instructions, and separately state each partner's distributive share of partnership section 1045 gain from the sale of QSB stock under section 702. Each partner shall de-

termine whether the partner is an eligible partner within the meaning of paragraph (g)(3) of this section and report the partner's distributive share of partnership section 1045 gain from the partnership's sale of QSB stock, including gain not recognized, in accordance with the applicable forms and instructions.

(ii) *Partner notification to partnership.* Any partner that must recognize all or part of the partner's distributive share of partnership section 1045 gain must notify the partnership, in writing, of the amount of partnership section 1045 gain that is recognized by the partner. Similarly, an eligible partner that opts out of a partnership's section 1045 election under paragraph (b)(4) of this section must notify the partnership, in writing, that the partner is opting out of the partnership's section 1045 election.

(c) *Partner election—(1) In general—(i) Rule.* An eligible partner of a partnership that sells QSB stock (selling partnership) may elect in accordance with paragraph (h) of this section to apply section 1045 if replacement QSB stock is purchased by the eligible partner. An eligible partner of a selling partnership may elect in accordance with paragraph (h) of this section to apply section 1045 if replacement QSB stock is purchased by a partnership in which the taxpayer is a partner (directly or through an upper-tier partnership) on the date on which the partnership acquires the replacement QSB stock (purchasing partnership). A taxpayer other than a C corporation that sells QSB stock held for more than 6 months at the time of the sale may elect in accordance with paragraph (h) of this section to apply section 1045 if replacement QSB stock is purchased by a purchasing partnership (including a selling partnership).

(ii) *Partner purchase of replacement QSB stock.* Subject to paragraph (d) of this section, an eligible partner of a selling partnership that elects to apply section 1045 with respect to the eligible partner's purchase of replacement QSB stock must recognize its distributive share of gain from the sale of QSB stock by the selling partnership only to the extent of the greater of—

(A) The amount of the eligible partner's distributive share of the selling partnership's gain from the sale of the QSB stock that is treated as ordinary income; or

(B) The excess of the eligible partner's share of the selling partnership's amount realized (as determined under paragraph (c)(2) of this section) on the sale by the selling partnership of the QSB stock (excluding the cost of any replacement QSB stock purchased by the selling partnership) over the cost of any replacement QSB stock purchased by the eligible partner (excluding the cost of any replacement QSB stock that is otherwise taken into account under section 1045).

(iii) *Partnership purchase of replacement QSB stock—(A) Partner of a selling partnership.* Subject to paragraph (d) of this section, an eligible partner that treats its interest in QSB stock purchased by a purchasing partnership as a purchase of replacement QSB stock by the eligible partner and that elects to apply section 1045 with respect to such purchase must recognize its total gain (the eligible partner's distributive share of gain from the selling partnership's sale of QSB stock and any gain taken into account under paragraph (c)(5) of this section from the sale of replacement QSB stock) only to the extent of the greater of—

(1) The amount of the eligible partner's distributive share of the selling partnership's gain from the sale of the QSB stock that is treated as ordinary income; or

(2) The excess of the eligible partner's share of the selling partnership's amount realized (as determined under paragraph (c)(2) of this section) on the sale by the selling partnership of the QSB stock (excluding the cost of any replacement QSB stock purchased by the selling partnership) over the eligible partner's share of the purchasing partnership's cost of the replacement QSB stock, as determined under paragraph (c)(3) of this section (excluding the cost of any QSB stock that is otherwise taken into account under section 1045).

(B) *Taxpayer other than a C corporation.* Subject to paragraph (d) of this section, a taxpayer other than a C corporation that treats its interest in QSB stock purchased by a purchasing partnership with respect to which the taxpayer is a partner as a purchase of replacement QSB stock by the taxpayer must recognize its gain from the sale of the QSB stock only to the extent of the greater of—

(1) The amount of gain from the sale of the QSB stock that is treated as ordinary income; or

(2) The excess of the amount realized by the taxpayer on the sale of the QSB stock over the partner's share of the purchasing partnership's cost of the replacement QSB stock, as determined under paragraph (c)(3) of this section (excluding the cost of any QSB stock that is otherwise taken into account under section 1045).

(2) *Eligible partner's share of amount realized by partnership*—(i)—*General rule.* The eligible partner's share of the amount realized by the selling partnership is the amount realized by the partnership on the sale of the QSB stock (excluding the cost of any replacement QSB stock otherwise taken into account under section 1045) multiplied by the following fraction—

(A) The numerator of which is the eligible partner's distributive share of the partnership's realized gain from the sale of the QSB stock; and

(B) The denominator of which is the partnership's realized gain on the sale of the QSB stock.

(ii) *General rule modified for determining eligible partner's share of amount realized by purchasing partnership upon a sale of replacement QSB stock in certain situations*—(A) *No gain realized or loss realized on sale of replacement QSB stock.* If a purchasing partnership does not realize a gain or realizes a loss from the sale of replacement QSB stock for which an election under this section was made for purposes of applying paragraph (c)(1)(iii)(A) of this section, the eligible partner's share of the amount realized is—

(1) The greater of—

(i) The amount determined in paragraph (c)(2)(i) of this section from a prior sale of QSB stock (that is not otherwise taken into account under paragraph (c)(2) of this section) in which the eligible partner had a distributive share of gain allocated to the eligible partner that was not recognized under paragraph (c)(1)(iii)(A) of this section; or

(ii) The amount realized by a taxpayer other than a C corporation from a prior sale of QSB stock (that is not otherwise taken into account under paragraph (c)(2) of this section) in which the taxpayer re-

alized gain that was not recognized under paragraph (c)(1)(iii)(B) of this section; less

(2) The eligible partner's distributive share of any loss recognized on the sale of replacement QSB stock, if applicable.

(B) *Eligible partner's interest in purchasing partnership is reduced and gain realized on sale of replacement QSB stock.* If an eligible partner's interest in a purchasing partnership is reduced subsequent to the sale of QSB stock and the purchasing partnership realizes a gain from the sale of the replacement QSB stock, the eligible partner's share of the amount realized upon a sale of replacement QSB stock must be determined under paragraph (c)(2)(i) of this section based on the distributive share of the partnership's realized gain that would have been allocated to the eligible partner if the eligible partner's interest in the partnership had not been reduced.

(iii) *Eligible partner's share of the amount realized.* For purposes of determining the eligible partner's share of the amount realized by the partnership, the partnership's realized gain from the sale of QSB stock and the eligible partner's distributive share of that gain are determined without regard to basis adjustments under section 743(b) and paragraphs (b)(3)(ii) and (c) of this section.

(3) *Partner's share of the cost of QSB stock purchased by a purchasing partnership.* The partner's share of the cost (adjusted basis) of replacement QSB stock purchased by a purchasing partnership is the percentage of the partnership's future income and gain, if any, that is reasonably expected to be allocated to the partner (determined without regard to any adjustment under section 1045) with respect to the replacement QSB stock that was purchased by the partnership, multiplied by the cost of that replacement QSB stock. The assumptions made by a partnership in determining the reasonably expected allocation of income and gain must be consistent for each partner. For example, a partnership may not treat the same item of income or gain as being reasonably expected to be allocated to more than one partner.

(4) *Basis adjustments*—(i) *Eligible partner's interest in selling partnership.* Under section 705(a)(1), the adjusted basis of an eligible partner's interest in a selling partnership that sells QSB stock is increased by the partner's distributive

share of gain without regard to paragraph (c)(1) of this section. However, if the selling partnership is also a purchasing partnership, the adjusted basis of an eligible partner's interest in a partnership that sells QSB stock may be reduced under paragraph (c)(4)(iii) of this section.

(ii) *Replacement QSB stock.* A partner's basis in any replacement QSB stock that is purchased by the partner, as well as the adjusted basis of any replacement QSB stock that is purchased by a purchasing partnership and that is treated as the partner's replacement QSB stock must be reduced (in the order replacement QSB stock is acquired by the partner and purchasing partnership, as applicable) by the partner's distributive share of the gain on the sale of the selling partnership's QSB stock that is not recognized by the partner under paragraph (c)(1) of this section, or by the gain on a sale of QSB stock by the partner that is not recognized by the partner under section 1045, as applicable. If replacement QSB stock is purchased by the purchasing partnership, the purchasing partnership shall maintain its adjusted basis in the replacement QSB stock without regard to any basis adjustments required by this paragraph (c)(4)(ii). The eligible partner, however, shall in computing its distributive share of income, gain, loss and deduction from the purchasing partnership with respect to the replacement QSB stock take into account the variation between the adjusted basis in the QSB stock as determined under this paragraph (c)(4)(ii) and the adjusted basis determined without regard to this paragraph (c)(4)(ii). A partner must retain records setting forth the computation of this basis adjustment, the replacement QSB stock to which the adjustment has been made, and the date(s) on which such stock was acquired. See *Examples 7 and 8* of paragraph (i) of this section.

(iii) *Partner's basis in purchasing partnership interest.* A partner that treats the partner's interest in QSB stock purchased by a purchasing partnership as the partner's replacement QSB stock must reduce (in the order replacement QSB stock is acquired) the adjusted basis of the partner's interest in the purchasing partnership by the partner's distributive share of the gain on the sale of the selling partnership's QSB stock that is not recognized by the partner pursuant to paragraph (c)(1) of this section, or by the gain on a sale of QSB stock

by the partner that is not recognized by the partner under section 1045, as applicable. Similarly, a partner of an upper-tier partnership that treats the partner's interest in QSB stock purchased by a lower-tier purchasing partnership as the partner's replacement QSB stock must reduce (in the order replacement QSB stock is acquired) the adjusted basis of the partner's interest in the upper-tier partnership by the partner's distributive share of the gain on the sale of the selling partnership's QSB stock that is not recognized by the partner pursuant to paragraph (c)(1) of this section, or by the gain on a sale of QSB stock by the partner that is not recognized by the partner under section 1045, as applicable.

(iv) *Increase in basis on sale of QSB stock by purchasing partnership.* A partner that recognizes gain under paragraph (c)(5) of this section must increase the adjusted basis of the partner's interest in the purchasing partnership under section 705(a)(1) by the amount of the gain recognized by that partner. Similarly, a partner in an upper-tier partnership that recognizes gain under paragraph (c)(5) of this section must increase the adjusted basis of the partner's interest in the upper-tier partnership under section 705(a)(1) by the amount of the gain recognized by that partner.

(5) *Partner recognition of gain.* At the time that either the partner or the purchasing partnership (whichever applies) sells or exchanges replacement QSB stock, the amount recognized by the partner is determined by taking into account the basis adjustments described in paragraph (c)(4)(ii) of this section. Similarly, a partner of an upper-tier partnership that owns an interest in a lower-tier partnership that holds replacement QSB stock must take into account the basis adjustments described in paragraph (c)(4)(ii) of this section in determining the amount recognized by the partner on a sale of the interest in the lower-tier partnership by the upper-tier partnership or the partner's distributive share of gain from the upper-tier partnership. See paragraph (e)(4) of this section for rules applicable to certain distributions of replacement QSB stock.

(d) *Nonrecognition limitation—(1) In general.* For purposes of this section, the amount of gain that an eligible partner does not recognize under paragraphs (b)(1) and (c)(1) of this section cannot exceed the nonrecognition limitation. Except as oth-

erwise provided in paragraph (d)(2) of this section, the nonrecognition limitation is equal to the product of—

(i) The partnership's realized gain from the sale of the QSB stock, determined without regard to any basis adjustment under section 734(b) or section 743(b) (other than basis adjustments described in paragraph (b)(3)(ii) of this section); and

(ii) The eligible partner's smallest percentage interest in partnership capital as determined in paragraph (d)(2) of this section. See *Example 9* of paragraph (i) of this section.

(2) *Eligible partner's smallest percentage interest in partnership capital.* An eligible partner's smallest percentage interest in partnership capital is the eligible partner's percentage share of capital determined at the time of the acquisition of the QSB stock as adjusted prior to the time the QSB stock is sold to reflect any reduction in the capital of the eligible partner including a reduction as a result of a disproportionate capital contribution by other partners, a disproportionate capital distribution to the eligible partner or the transfer of an interest by the eligible partner, but excluding income and loss allocations.

(3) *Special rule for tiered partnerships.* For purposes of paragraph (d)(1)(ii) of this section, if an eligible partner is treated as owning an interest in a lower-tier purchasing partnership through an upper-tier partnership, the eligible partner's percentage interest in the purchasing partnership shall be proportionately adjusted to reflect the eligible partner's percentage interest in the upper-tier partnership.

(e) *Partnership distribution of QSB stock to a partner—(1) In general.* Subject to paragraphs (e)(2) and (3) of this section, in the case of a partnership distribution of QSB stock to a partner, the partner shall be treated for purposes of this section as—

(i) Having acquired such stock in the same manner as the partnership; and

(ii) Having held such stock during any continuous period immediately preceding the distribution during which it was held by the partnership. See *Examples 10* and *11* of paragraph (i) of this section.

(2) *Eligibility under section 1202(c).* Paragraph (e)(1) of this section does not apply unless all eligibility requirements with respect to QSB stock as defined in section 1202(c) are met by the distributing

partnership with respect to its investment in QSB stock.

(3) *Distribution nonrecognition limitation—(i) Generally.* The amount of gain that an eligible partner does not recognize under this section on the sale of QSB stock that was distributed by the partnership to the partner cannot exceed the distribution nonrecognition limitation. For this purpose, the distribution nonrecognition limitation is—

(A) The partner's section 1045 amount realized (determined under paragraph (e)(3)(ii) of this section); reduced by

(B) The partner's section 1045 adjusted basis (determined under paragraph (e)(3)(iii) of this section).

(ii) *Section 1045 amount realized—(A) QSB stock received in liquidation of partner's interest and in certain nonliquidating distributions.* If a partner receives QSB stock from the partnership in a distribution in liquidation of the partner's interest in the partnership or as part of a series of related distributions by the partnership in which the partnership distributes all of the partnership's QSB stock of a particular type, then the partner's section 1045 amount realized is the partner's amount realized from the sale of the distributed QSB stock, multiplied by a fraction—

(1) The numerator of which is the partner's smallest percentage interest in partnership capital determined under paragraph (e)(3)(ii)(B) of this section; and

(2) The denominator of which is the partner's percentage interest in that type of QSB stock immediately after the distribution (determined under paragraph (e)(3)(iv) of this section).

(B) *Partner's smallest percentage interest in partnership capital.* A partner's smallest percentage interest in partnership capital is the partner's percentage share of capital determined at the time of the acquisition of the QSB stock as adjusted prior to the time the QSB stock is distributed to the partner to reflect any reduction in the capital of the partner including a reduction as a result of a disproportionate capital contribution by other partners, a disproportionate capital distribution to the partner, or the transfer of a capital interest by the partner, but excluding income and loss allocations.

(C) *QSB stock received in other distributions.* If a partner receives QSB stock in a distribution from the partnership that is not described in paragraph (e)(3)(ii)(A)

of this section, the partner's section 1045 amount realized is the partner's amount realized from the sale of the distributed QSB stock multiplied by the partner's smallest percentage interest in partnership capital determined under paragraph (e)(3)(ii)(B) of this section.

(iii) *Section 1045 adjusted basis*—(A) *QSB stock received in liquidation of partner's interest and in certain nonliquidating distributions.* If a partner receives QSB stock from the partnership in a distribution in liquidation of the partner's interest in the partnership or as part of a series of related distributions by the partnership in which the partnership distributes all of the partnership's QSB stock of a particular type, then the partner's section 1045 adjusted basis is the product of—

(1) The partnership's basis in all of the QSB stock of the type distributed (without regard to basis adjustments under section 734(b) or section 743(b), other than basis adjustments described in paragraphs (b)(3)(ii) and (c)(4)(ii) of this section);

(2) The partner's smallest percentage interest in partnership capital determined under paragraph (e)(3)(ii)(B) of this section; and

(3) The proportion of the distributed QSB stock that was sold by the partner.

(B) *QSB stock received in other distributions.* If a partner receives QSB stock in a distribution from the partnership that is not described in paragraph (e)(3)(iii)(A) of this section, the partner's section 1045 adjusted basis is the product of—

(1) The partnership's basis in the QSB stock sold by the partner (without regard to basis adjustments under section 734(b) or section 743(b), other than basis adjustments described in paragraphs (b)(3)(ii) and (c)(4)(ii) of this section); and

(2) The partner's smallest percentage interest in partnership capital determined under paragraph (e)(3)(ii)(B) of this section.

(iv) *Partner's percentage interest in distributed QSB stock.* For purposes of this paragraph (e)(3), a partner's percentage interest in a type of QSB stock immediately after a partnership distribution is the value (as of the date of the distribution) of the QSB stock distributed to the partner divided by the value (as of the date of the distribution) of all of that type of QSB stock that was acquired by the partnership.

(v) *QSB stock of the same type.* For purposes of this paragraph (e)(3), QSB stock will be of the same type as the distributed QSB stock if it has the same issuer and the same rights and preferences as the distributed QSB stock and was acquired by the partnership at original issue.

(4) *Distribution of replacement QSB stock to a partner that reduces another partner's interest in the replacement QSB stock.* For purposes of this section, a partner must recognize gain upon a distribution of replacement QSB stock to another partner that reduces the partner's share of the replacement QSB stock held by a partnership. The amount of gain that the partner must recognize is determined based on the amount of gain that the partner would recognize upon a sale of the distributed replacement QSB stock for its fair market value on the date of the distribution but not to exceed the amount that was previously not recognized by the partner under section 1045 with respect to the distributed replacement QSB stock. Any gain recognized by a partner whose interest is reduced must be taken into account in determining the adjusted basis of the partner's interest in the partnership and also taken into account in determining the partnership's adjusted basis in the QSB stock distributed to another partner under paragraph (e)(3) of this section.

(f) *Contribution of QSB stock or replacement QSB stock to a partnership.* Section 721 applies to a contribution of QSB stock to a partnership. Except as provided in section 721(b), any gain that was not recognized by the taxpayer under section 1045 is not recognized when the taxpayer contributes QSB stock to a partnership in exchange for a partnership interest. Stock that is contributed to a partnership is not QSB stock in the hands of the partnership. See *Example 12* of paragraph (i) of this section.

(g) *Definitions.* For purposes of section 1045 and this section, the following terms are defined as follows:

(1) *Qualified small business stock.* The term *qualified small business stock* (QSB stock) has the meaning provided in section 1202(c). The term "QSB stock" does not include an interest in a partnership that purchases or holds QSB stock. See *Example 1* of paragraph (i) of this section.

(2) *Replacement QSB stock.* The term *replacement QSB stock* is any QSB stock

purchased within 60 days beginning on the date of a sale of QSB stock.

(3) *Eligible partner*—(i) *In general.* Except as provided in paragraphs (e)(1), (g)(3)(ii), (iii) and (iv) of this section, an eligible partner with respect to QSB stock is a taxpayer other than a C corporation that holds an interest in a partnership on the date the partnership acquires the QSB stock and at all times thereafter for more than 6 months until the partnership sells or distributes the QSB stock.

(ii) *Acquisition by gift or at death.* For purposes of paragraph (g)(3)(i) of this section, a taxpayer who acquires from a partner (other than a C corporation) by gift or at death an interest in a partnership that holds QSB stock is treated as having held the acquired interest in the partnership during the period the partner (other than a C corporation) held the interest in the partnership.

(iii) *Tiered partnership.* For purposes of paragraph (g)(3)(i) of this section, if a partnership (upper-tier partnership) holds an interest in another partnership (lower-tier partnership) that holds QSB stock, then the upper-tier partnership's ownership of the lower-tier partnership is disregarded and each partner of the upper-tier partnership is treated as owning the interest in the lower-tier partnership directly. The partner of the upper-tier partnership is treated as owning the interest in the lower-tier partnership during the period in which both—

(A) The partner of the upper-tier partnership held an interest in the upper-tier partnership; and

(B) The upper-tier partnership held an interest in the lower-tier partnership. See *Examples 3* and *4* of paragraph (i) of this section.

(iv) *Multiple tiers of partnerships.* Principles similar to those described in paragraph (g)(3)(iii) of this section apply where a taxpayer holds an interest in a lower-tier partnership through multiple tiers of partnerships.

(4) *Month(s).* For purposes of this section, the term *month(s)* means a period commencing on the same numerical day of any calendar month as the day on which the QSB stock is sold and ending with the close of the day preceding the numerically corresponding day of the succeeding calendar month or, if there is no corresponding day, with the last day of the succeeding calendar month.

(h) *Reporting and election rules*—(1) *Time and manner of making election.* A partnership making an election under section 1045 (as described under paragraph (b)(1) of this section) must do so on the partnership's timely filed (including extensions) Federal income tax return for the taxable year during which the sale of QSB stock occurs. A partner making an election under section 1045 (as described under paragraph (c)(1) of this section) must do so on the partner's timely filed (including extensions) Federal income tax return for the taxable year during which the partner's distributive share of the partnership's gain from the sale of the QSB stock is taken into account by such partner under section 706. In addition, a partnership or partner making an election under section 1045 must make such election in accordance with the applicable forms and instructions.

(2) *Purchases, distributions, and sales of QSB stock or replacement QSB stock by partnerships.* A partnership that purchases, distributes to a partner, or sells or exchanges QSB stock or replacement QSB stock must provide information to the Commissioner and to the partnership's partners to the extent provided by the applicable forms and instructions.

(3) *Nonrecognition of gain by eligible partners.* An eligible partner that does not recognize gain under section 1045 must provide information to the Commissioner to the extent provided by the applicable forms and instructions.

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

Example 1. Sale of a partnership interest. On January 1, 2008, A, an individual, X, a C corporation, and Y, a C corporation, form PRS, a partnership. A, X, and Y each contribute \$250 to PRS and agree to share all partnership items equally. PRS purchases QSB stock for \$750 on February 1, 2008. On November 4, 2008, A sells A's interest in PRS for \$500, realizing \$250 of capital gain. Under paragraph (g)(1) of this section, an interest in a partnership that holds QSB stock is not treated as QSB stock. Therefore, the sale of an interest in a partnership that holds QSB stock is not treated as a sale of QSB stock, and A may not elect to apply section 1045 with respect to A's \$250 gain from the sale of A's interest in PRS.

Example 2. Election by partner; replacement by partnership. (i) Assume the same facts as in *Example 1*, except that A does not sell A's interest in PRS. Instead, PRS sells the QSB stock (QSB1 stock) for \$1,500 on November 3, 2008. PRS realizes \$750 of gain from the sale of the QSB1 stock (none of which is treated as ordinary income) and allocates \$250 of

gain to each of A, X, and Y. PRS does not make a section 1045 election. On November 30, 2008, A contributes \$500 to ABC, a partnership, in exchange for a 10 percent interest in ABC. ABC then purchases QSB stock (QSB2 stock) for \$5,000 on December 1, 2008. ABC has no other assets. A makes an election under paragraph (c)(1) of this section and treats A's percentage interest in ABC's QSB2 stock as replacement QSB stock under paragraph (c)(1)(iii) of this section with respect to the \$250 gain PRS allocated to A. Under paragraph (c)(3) of this section, A's share of the cost of QSB2 stock purchased by ABC is \$500 (A's reasonably expected income and gain with respect to QSB2 stock, or 10 percent multiplied by the cost of the QSB2 stock, \$5,000). Under paragraph (c)(1)(iii) of this section, A will not recognize the \$250 gain PRS allocated to A, because A's share of the amount realized by PRS, \$500 (the total amount realized by the partnership on the sale of the QSB1 stock (\$1,500) multiplied by A's share of the gain from the sale of the QSB1 stock (\$250) over the total gain realized by the partnership on the sale of the QSB1 stock (\$750)), does not exceed A's share of ABC's cost of the QSB2 stock acquired by ABC, \$500. Under paragraph (c)(4)(ii) of this section, A must reduce A's share of ABC's basis in the QSB2 stock by \$250. Under paragraph (c)(4)(iii) of this section, A must reduce A's basis in A's interest in ABC by \$250. Under paragraph (c)(4)(i) of this section, A's basis in A's interest in PRS is increased by \$250.

(ii) Assume the same facts as in paragraph (i) of this *Example 2*, except that A does not contribute \$500 to ABC in exchange for a partnership interest. Instead, on November 30, 2008, EFG, a partnership in which A has an existing 10 percent partnership interest, purchases QSB stock for \$5,000. Under paragraph (c)(1) of this section, A may treat A's 10 percent interest in EFG's QSB stock as replacement QSB stock with respect to the \$250 of gain PRS allocated to A.

(iii) Assume the same facts as in paragraph (i) of this *Example 2*, except that ABC owns QSB stock that ABC purchased on November 10, 2008, and ABC does not purchase QSB stock on December 1, 2008. Under paragraph (c)(1) of this section, ABC is not a purchasing partnership with respect to A for the QSB stock ABC purchased on November 10, 2008. A may not treat A's percentage interest in ABC's QSB stock as replacement QSB stock to defer the \$250 gain PRS allocated to A, because A acquired its interest in ABC after ABC acquired the QSB stock.

(iv) Assume the same facts as in paragraph (i) of this *Example 2*, except that ABC sells QSB2 stock on July 30, 2009, for \$5,000. ABC realizes no gain or loss on the sale of QSB2 stock. A desires to continue to rollover the \$250 gain from the sale of QSB1 stock. Under paragraph (c)(2)(ii)(A) of this section, A's share of the amount realized is \$500, which was A's share of the amount realized on the prior sale of QSB1 stock. Accordingly, A must elect to apply section 1045 and purchase \$500 of replacement QSB stock either directly or through a purchasing partnership to continue to defer the \$250 gain from the sale of QSB1 stock.

Example 3. Tiered partnerships; partnership election. (i) On January 1, 2008, A, an individual, and B, an individual, each contribute \$500 to UTP, (upper-tier partnership) for equal partnership interests. On February 1, 2008, UTP and C, an individual,

each contribute \$1,000 to LTP, (lower-tier partnership) for equal partnership interests. On March 1, 2008, LTP purchases QSB stock for \$500. On April 1, 2008, D, an individual, joins UTP by contributing \$500 to UTP for a 1/3 interest in UTP. On December 1, 2008, LTP sells the QSB stock for \$2,000. Under paragraph (g)(3)(iii) of this section, A, B, and D are treated as owning an interest in LTP during the period in which each of the partners held an interest in UTP and UTP held an interest in LTP. Therefore, under paragraphs (g)(3)(i) and (iii) of this section, A and B are eligible partners, and D and UTP are not eligible partners with respect to the QSB stock sold by LTP. Under paragraph (g)(3)(i) of this section, C is also an eligible partner with respect to the QSB stock sold by LTP.

(ii) Assume the same facts as in paragraph (i) of this *Example 3*. LTP realizes a gain of \$1,500 on the December 1, 2008, sale of QSB stock. LTP allocates \$750 of gain to each of UTP and C. UTP, in turn, allocates \$250 (of the \$750 of gain allocated to UTP) to each of A, B, and D. LTP makes a section 1045 election. On January 1, 2009, LTP purchases replacement QSB stock for \$2,000. Under paragraph (b)(5)(ii) of this section, D notifies UTP that it recognizes \$250 of gain and UTP notifies LTP. Because A, B, and C are eligible partners with respect to the QSB stock sold by LTP, A and B may each defer \$250 of LTP's section 1045 gain and C may defer \$750 of LTP's section 1045 gain. LTP must decrease its basis in the replacement QSB stock by the \$750 of partnership section 1045 gain that was allocated to C and by \$500 of the partnership section 1045 gain that was allocated to UTP. These basis reductions are with respect to UTP (A and B) and C only. Under paragraph (b)(3)(ii)(B) of this section, the basis of UTP's interest in LTP attributable to the LTP's replacement QSB stock must be segregated and allocated to A and B. In addition, A and B each have a \$250 negative basis adjustment in their respective interests in UTP. If UTP sells its interest in LTP for \$1,250, A and B would each recognize \$250 of gain from the sale of the LTP interest. D would not recognize any gain or loss from the sale.

Example 4. Tiered partnerships; partner election.

(i) On January 1, 2008, A, an individual, and X, a C corporation, form UTP, a partnership. A and X each contribute \$250 to UTP and agree to share all partnership items equally. Also, on January 1, 2008, UTP and Y, a C corporation, form LTP, a partnership. UTP and Y contribute \$500 and \$250, respectively, to LTP. UTP and Y agree to share all partnership items equally. LTP purchases QSB stock for \$750 on February 1, 2008. On November 3, 2008, LTP sells the QSB stock for \$1,500. LTP realizes \$750 of gain from the sale of the QSB stock (none of which is treated as ordinary income) and allocates \$250 gain to Y and \$500 gain to UTP. Of the \$500 gain allocated to UTP from the sale of QSB stock, \$250 is allocated to A and \$250 is allocated to X. LTP purchases replacement QSB stock (replacement QSB1 stock) for \$1,350 on December 15, 2008. LTP does not make an election under section 1045. Under the rules provided in paragraph (c) of this section, A makes an election under section 1045 on its timely filed return for the taxable year for which the distributive share of gain from the sale of QSB stock is taken into account by A under section 706. Under paragraph (c)(1)(iii) of this section, A treats A's interest in replacement QSB1 stock as replacement stock with respect to A's

distributive share of LTP's section 1045 gain. On March 30, 2009, LTP sells replacement QSB1 stock for \$1,650. LTP realizes \$300 of gain from the sale of replacement QSB1 stock (none of which is treated as ordinary income) and allocates \$100 to Y and \$200 to UTP.

(ii) Under paragraph (c)(1)(iii) of this section, A must recognize its distributive share of gain from LTP's sale of QSB stock (\$250) only to the extent of the greater of A's distributive share of LTP's gain from the sale of QSB stock that is treated as ordinary income (\$0) or the amount by which A's share of the amount realized by LTP's sale of QSB stock exceeds A's share of LTP's cost of the replacement QSB1 stock, \$50 ($1/3^{\text{rd}}$ of \$1,500, or \$500, minus $1/3^{\text{rd}}$ of \$1,350, or \$450). Because Y is not an eligible partner of LTP under paragraph (g)(3) of this section, Y must recognize its \$250 distributive share of partnership gain from the sale of the QSB stock. Also, X is not an eligible partner under paragraph (g)(3) of this section, and it must recognize its \$250 distributive share of gain from UTP attributable to UTP's distributive share of \$500 of LTP's gain from the sale of QSB stock.

(iii) Under section 705(a)(1), the adjusted basis of Y's interest in LTP is increased by \$250, and the adjusted basis of UTP's interest in LTP is increased by \$500. Under section 705(a)(1), the adjusted basis of X's interest in UTP is increased by \$250, and the adjusted basis of A's interest in UTP is increased by \$250. However, under paragraph (c)(4)(iii) of this section, the adjusted basis of A's interest in UTP is reduced by the \$200 of partnership section 1045 gain that was not recognized by A.

(iv) Under paragraph (c)(4)(ii) of this section, the LTP's adjusted basis in replacement QSB1 stock is reduced by the \$200 of gain from the sale of QSB stock that is not recognized by A, as a result of A's election under section 1045. A must retain records setting forth the computation of this basis adjustment, the replacement QSB stock to which the adjustment is made, and dates the stock was acquired. LTP's adjusted basis in the replacement QSB1 stock is maintained without regard to the eligible partner's adjustment provided in paragraph (c)(4)(ii) of this section.

(v) On the sale of replacement QSB1 stock, LTP realizes a gain of \$300, \$100 of which is allocated to Y and \$200 of which is allocated to UTP. UTP allocates \$100 of this gain to A. Under paragraph (c)(5) of this section, in determining A's amount recognized upon the sale of replacement QSB1 stock by LTP, A must take into account A's basis adjustment of \$200. Accordingly, A recognizes a total gain of \$300 upon the sale of replacement QSB1 stock, absent an additional section 1045 election by A or LTP. Under paragraph (c)(4)(iv) of this section, the adjusted basis of A's interest in UTP is increased by \$300 under section 705(a)(1).

(vi) Assume the same facts as in paragraph (i) of this *Example 4*, except that UTP sells its entire interest in LTP on March 30, 2009, for \$1,200. UTP realizes a gain of \$200 on the sale of its interest in LTP (\$1,200 amount realized less \$1,000 adjusted basis) and allocates \$100 of this gain to A. Under paragraph (c)(5) of this section, in determining A's amount recognized upon the sale of UTP's interest in LTP, A must take into account A's basis adjustment of \$200. Accordingly, A recognizes a total gain of \$300 upon the sale of the interest in LTP. Under para-

graph (c)(4)(iv) of this section, the adjusted basis in A's interest in UTP is increased by \$300 under section 705(a)(1).

Example 5. Partnership sale of QSB stock and purchase and sale of replacement QSB stock. (i) On January 1, 2008, A, an individual, X, a C corporation, and Y, a C corporation, form PRS, a partnership. A, X, and Y each contribute \$250 to PRS and agree to share all partnership items equally. PRS purchases QSB stock for \$750 on February 1, 2008. On November 3, 2008, PRS sells the QSB stock for \$1,500. PRS realizes \$750 of gain from the sale of the QSB stock (none of which is treated as ordinary income) and allocates \$250 of gain to each of A, X, and Y. PRS purchases replacement QSB stock (replacement QSB1 stock) for \$1,350 on December 15, 2008. On its timely filed return for the taxable year during which the sale of the QSB stock occurs, PRS makes an election to apply section 1045. A does not make an election to apply section 1045 with respect to the November 3, 2008, sale of QSB stock. PRS knows that X and Y are C corporations. On March 30, 2009, PRS sells replacement QSB1 stock for \$1,650. PRS realizes \$300 of gain from the sale of replacement QSB1 stock (none of which is treated as ordinary income) and allocates \$100 of gain to each of A, X, and Y. A does not make an election to apply section 1045 with respect to the March 30, 2009, sale of replacement QSB1 stock.

(ii) Under paragraph (b)(1) of this section, the partnership section 1045 gain from the November 3, 2008, sale of QSB stock is \$600 (\$750 gain less \$150 (\$1,500 amount realized on the sale of QSB stock less \$1,350 cost of replacement QSB1 stock)). This amount must be allocated among the partners in the same proportions as the entire gain from the sale of QSB stock is allocated to the partners, $1/3$ (\$200) to A, $1/3$ (\$200) to X, and $1/3$ (\$200) to Y.

(iii) Because neither X nor Y is an eligible partner under paragraph (g)(3) of this section, X and Y must each recognize its \$250 distributive share of partnership gain from the sale of QSB stock. Because A is an eligible partner under paragraph (g)(3) of this section, A may defer recognition of A's \$200 distributive share of partnership section 1045 gain. A is not required to separately elect to apply section 1045. A must recognize A's remaining \$50 distributive share of the partnership's gain from the sale of QSB stock.

(iv) Under section 705(a)(1), the adjusted bases of X's and Y's interests in PRS are each increased by \$250. Under section 705(a)(1) and paragraph (b)(3)(i) of this section, the adjusted basis of A's interest in PRS is not increased by the \$200 of partnership section 1045 gain that was not recognized by A, but is increased by A's remaining \$50 distributive share of gain.

(v) PRS must decrease its basis in the replacement QSB1 stock by the \$200 of partnership section 1045 gain that was allocated to A. This basis reduction is a reduction with respect to A only. PRS then adjusts A's distributive share of gain from the sale of replacement QSB1 stock to reflect the effect of A's basis adjustment under paragraph (b)(3)(ii) of this section. In accordance with the principles of §1.743-1(j)(3), the amount of A's gain from the March 30, 2009, sale of replacement QSB1 stock in which A has a \$200 negative basis adjustment equals \$300 (A's share of PRS's gain from the sale of replacement QSB1 stock (\$100), increased by the amount of A's negative basis

adjustment for replacement QSB1 stock (\$200)). Accordingly, upon the sale of replacement QSB1 stock, A recognizes \$300 of gain, and X and Y each recognize \$100 of gain.

(vi) Assume the same facts as in paragraph (i) of this *Example 5*, except that PRS purchases replacement QSB stock (replacement QSB2 stock) on April 15, 2009, for \$1,150 and PRS makes an election to apply section 1045 with respect to the March 30, 2009, sale of replacement QSB1 stock. Under paragraph (b)(3)(ii)(A) of this section, PRS' \$200 basis adjustment in QSB1 stock relating to the November 3, 2008, sale of QSB stock carries over to the basis adjustment for QSB2 stock. This basis adjustment is an adjustment with respect to A only. The \$200 basis adjustment is reduced by A's distributive share of the excess of \$500 (the greater of the amount determined under paragraph (b)(1)(i), \$0, or (ii) of this section, \$500 (\$1,650 amount realized on the sale of QSB1 stock less \$1,150 cost of replacement QSB2 stock)) over \$300 (PRS' gain from the sale of QSB1 stock), or \$67 (\$200 (\$500 minus \$300) divided by 3). Under paragraph (b)(3)(ii)(A), A must account for the \$67 excess amount that reduces PRS' basis adjustment in QSB2 stock as gain in accordance with §1.743-1(j)(3). Therefore, A now has a \$133 negative basis adjustment with respect to replacement QSB2 stock ((\$200) negative basis adjustment from the November 3, 2008, sale of QSB stock plus \$67 positive basis adjustment from the March 30, 2009, sale of QSB1 stock). A also recognizes the \$100 of gain allocated by PRS to A from the March 30, 2009, sale of replacement QSB1 stock for total gain recognition of \$167 (\$100 plus \$67).

Example 6. Partnership sale of QSB stock; election by eligible partner; replacement QSB stock purchased by purchasing partnership. (i) Assume the same facts as in *Example 5* except that PRS does not make an election under section 1045 with respect to the sale of either the QSB stock on November 3, 2008, or the QSB1 stock on March 30, 2009. However, A makes an election under section 1045 with respect to the sale of QSB stock and treats the purchase of QSB1 stock on December 15, 2008, by PRS, as the purchase of replacement QSB stock. Additionally, A makes an election under section 1045 with respect to the sale of QSB1 stock and treats the purchase of QSB2 stock on April 15, 2009, by PRS, as the purchase of replacement QSB stock.

(ii) A's distributive share of gain from the November 3, 2008, sale of QSB stock is \$250 (A's $1/3$ interest in \$750 of total PRS gain). Under paragraph (c)(1)(iii) of this section, A must recognize only \$50 of A's distributive share of PRS' gain of \$250, that is the excess of A's share of the amount realized on the sale of QSB stock, or \$500 (the total amount realized by PRS on the sale of QSB stock (\$1,500) multiplied by A's share of the gain from the sale of QSB stock (\$250) over the total gain realized by PRS on the sale of QSB stock (\$750)), minus A's share of PRS' cost of QSB1 stock, or \$450 ($1/3$ of \$1,350). Under section 705(a)(1) and paragraph (c)(4)(i) of this section, A's adjusted basis in its interest in PRS is increased by \$250. However, under paragraph (c)(4)(iii) of this section, because PRS is a purchasing partnership, A's adjusted basis of its interest in PRS is then reduced by the deferred gain of \$200. Also under paragraph (c)(4)(ii) of this section, PRS' adjusted basis in QSB1 stock is reduced by the gain not recognized of \$200

and A must take into account such adjusted basis in computing A's income, gain, loss or deduction with respect to QSB1 stock. A must retain records setting forth the computation of this basis adjustment, the replacement QSB stock to which the adjustment is made, and dates the stock was acquired.

(iii) A's distributive share of gain from the March 30, 2009, sale of QSB1 stock is \$100 (A's $\frac{1}{3}$ interest in \$300 of total PRS gain) and under paragraph (c)(5) of this section, A must take into account A's \$200 basis adjustment with respect to the QSB1 stock that was sold. Accordingly, A's total gain from the sale of QSB1 stock is \$300. Under paragraph (c)(1)(iii) of this section, A must recognize only \$167 of A's total gain of \$300, that is, the excess of A's share of the amount realized on the sale of QSB1 stock, or \$550 (the total amount realized by PRS on the sale of QSB1 stock (\$1,650) multiplied by A's share of the gain from the sale of QSB1 stock (\$100) over the total gain realized by PRS on the sale of QSB1 stock (\$300)) minus A's share of PRS' cost of QSB2 stock, or \$383 ($\frac{1}{3}$ of \$1,150). Under section 705(a)(1), A's adjusted basis in A's interest in PRS is increased by A's \$100 distributive share of gain from the sale of QSB1 stock. Under paragraph (c)(4)(iv) of this section, A's adjusted basis of A's interest in PRS is increased by the additional \$67 of gain recognized under paragraph (c)(5) of this section. Also, under paragraph (c)(4)(ii) of this section, PRS' adjusted basis in QSB2 stock is reduced by the gain not recognized of \$133 (\$300 minus \$167) and A must take into account such adjusted basis in computing A's income, gain, loss or deduction with respect to QSB2 stock. A must retain records setting forth the computation of this basis adjustment, the replacement QSB stock to which the adjustment is made, and dates the stock was acquired.

Example 7. Partnership sale of QSB stock and partner purchase of replacement QSB stock. (i) Assume the same facts as in paragraph (i) of *Example 5*, except that PRS does not make an election under section 1045 with respect to the sale of the QSB stock and does not purchase replacement QSB stock. On November 30, 2008, A, an eligible partner under paragraph (g)(3) of this section, purchases replacement QSB stock for \$500. A elects pursuant to paragraph (c) of this section to apply section 1045 on A's timely filed return for the taxable year that A is required to include A's distributive share of PRS' gain from the sale of the QSB stock.

(ii) Under paragraph (c)(2) of this section, A's share of the amount realized from PRS' sale of the QSB stock is \$500 (the total amount realized by the partnership on the sale of the QSB stock (\$1,500) multiplied by A's share of the gain from the sale of the QSB stock (\$250) over the total gain realized by the partnership on the sale of the QSB stock (\$750)). Because A purchased, within 60 days of PRS' sale of the QSB stock, replacement QSB stock for a cost equal to A's share of the partnership's amount realized on the sale of the QSB stock, and because A made an election pursuant to paragraph (c) of this section to apply section 1045, A defers recognition of A's \$250 distributive share of gain from PRS' sale of the QSB stock. Under section 705(a)(1) and paragraph (c)(4)(i) of this section, the adjusted basis of A's interest in PRS is increased by \$250. Under paragraph (c)(4)(ii) of this section, A's adjusted basis in the re-

placement QSB stock is \$250 (\$500 cost minus \$250 nonrecognition amount).

Example 8. Partial replacement by partnership; partial replacement by partner. (i) On January 1, 2008, A, an individual, and X, a C corporation, form PRS, a partnership. A and X each contribute \$500 to PRS and agree to share all partnership items equally. PRS purchases QSB stock on February 1, 2008, for \$1,000 and subsequently sells the QSB stock on January 31, 2010, for \$3,000. PRS realizes \$2,000 of gain from the sale of the QSB stock (none of which is treated as ordinary income) and allocates \$1,000 of gain to each of A and X. On February 10, 2010, PRS purchases replacement QSB stock for \$2,200. On March 20, 2010, A purchases replacement QSB stock for \$400. PRS makes an election to apply section 1045 under paragraph (b)(1) of this section with respect to the partnership section 1045 gain from the sale of QSB stock and A does not opt out of PRS' section 1045 election under paragraph (b)(4) of this section. Also, A makes an election under paragraph (c)(1) of this section with respect to the remaining gain from the sale of the QSB stock.

(ii) Under paragraph (b)(1) of this section, partnership section 1045 gain is \$1,200 (\$2,000 less \$800 (\$3,000 amount realized on the sale of the QSB stock minus \$2,200 cost of the replacement QSB stock)). This amount is allocated among the partners in the same proportions as the entire gain from the sale of the QSB stock is allocated to the partners, $\frac{1}{2}$ to A (\$600), and $\frac{1}{2}$ to X (\$600). Because A is an eligible partner, A defers recognition of A's \$600 distributive share of partnership section 1045 gain.

(iii) A also made an election under section 1045 and purchased, within 60 days of PRS' sale of the QSB stock, replacement QSB stock for \$400. Therefore, under paragraph (c)(1) of this section, A may defer a portion of A's distributive share of the remaining gain from the partnership's sale of the QSB stock. A must recognize that remaining gain to the extent that A's share of the amount realized by PRS on the sale of the QSB stock (excluding the cost of the QSB stock that was replaced by PRS) exceeds the cost of the replacement QSB stock purchased by A during the 60-day period following the sale of the QSB stock. The amount realized by PRS on the sale of the QSB stock (excluding the cost of the QSB stock that was replaced by PRS) is \$800 (\$3,000 minus \$2,200). Under paragraph (c)(2) of this section, A's share of that amount realized is \$400 ($\frac{1}{2}$ of \$800). Because the replacement QSB stock purchased by A cost \$400, A defers recognition of all of the remaining gain from the sale of the QSB stock.

(iv) The adjusted basis of A's interest in PRS is not increased by the \$600 gain that was not recognized pursuant to paragraph (b)(1) of this section, but is increased by the \$400 gain that was not recognized pursuant to paragraph (c)(1) of this section. See paragraphs (b)(3)(i) and (c)(4)(i) of this section. PRS must decrease its basis in the replacement QSB stock by the \$600 of partnership section 1045 gain that was allocated to A. See paragraph (b)(3)(ii) of this section. A must decrease A's basis in the replacement QSB stock purchased by A by the \$400 not recognized pursuant to paragraph (c)(1) of this section. See paragraph (c)(4)(ii) of this section.

Example 9. Change in partner's interest in partnership while partnership holds QSB stock. (i) On January 1, 2008, A, an individual, and X, a C corporation, form PRS, a partnership. A and X each contribute \$500 to PRS and agree to share all partnership items equally. PRS purchases QSB stock on February 1, 2008, for \$1,000. On August 2, 2008, A sells a 25 percent interest in PRS to Z. On July 10, 2009, A repurchases the 25 percent interest from Z for \$500. PRS makes a timely election under section 754 for the 2008 taxable year. Under section 743(b), A has a positive basis adjustment of \$250. On January 31, 2011, PRS sells the QSB stock for \$3,000. PRS realizes \$2,000 of gain from the sale of the QSB stock (none of which is treated as ordinary income) and allocates \$1,000 of gain to each of A and X. On February 10, 2010, PRS purchases replacement QSB stock for \$3,000. PRS makes an election to apply section 1045 under paragraph (b)(1) of this section with respect to the partnership section 1045 gain from the sale of QSB stock.

(ii) Of the \$2,000 of realized gain from the sale of the QSB stock, PRS allocates \$1,000 to A and \$1,000 to X. However, A has a positive basis adjustment of \$250 under section 743(b) as a result of the purchase of the 25 percent interest in PRS from Z; therefore, A's share of the gain is reduced to \$750. Because A is an eligible partner under paragraph (g)(3) of this section, A may defer recognition of A's distributive share of gain from the sale of the QSB stock subject to the nonrecognition limitation described in paragraph (d) of this section. The smallest percentage interest that A held in PRS capital during the time that PRS held the QSB stock is 25 percent. Under the nonrecognition limitation, A may not defer more than 25 percent of the partnership gain realized from the sale of the QSB stock (determined without regard to any basis adjustment under section 734(b) or section 743(b), other than a basis adjustment described in paragraph (b)(3)(ii) of this section). Because the partnership's realized gain determined without regard to A's basis adjustment under section 743(b) is \$2,000, A may defer recognition of \$500 (25 percent of \$2,000) of the gain from the sale of the QSB stock. A must recognize the remaining \$250 of that gain.

Example 10. Sale by partner of QSB stock received in a liquidating distribution. (i) On January 1, 2008, A, an individual, and X, a C corporation, form PRS, a partnership. A and X each contribute \$1,500 to PRS and agree to share all partnership items equally. PRS purchases QSB stock on February 1, 2008, for \$3,000. On May 1, 2008, when the QSB stock has appreciated in value to \$4,000, A contributes \$1,000 to PRS, increasing A's interest in PRS capital to 60 percent. On June 1, 2011, when the QSB stock is still worth \$4,000, PRS makes a liquidating distribution of \$3,000 worth of QSB stock to A. Under section 732, A's basis in the distributed QSB stock is \$2,500. A sells the QSB stock on August 4, 2011, for \$6,000, realizing a gain of \$3,500 (none of which is treated as ordinary income). A purchases replacement QSB stock on August 30, 2011, for \$5,500, and makes an election under section 1045 with respect to the August 4, 2011, sale of QSB stock.

(ii) A is an eligible partner under paragraph (g)(3) of this section. Therefore, under paragraph (e)(1) of this section, A is treated as having acquired the distributed QSB stock in the same manner as PRS and as

having held the QSB stock since February 1, 2008, its original issue date. Because A purchased, within 60 days of A's sale of the QSB stock, replacement QSB stock, A is eligible to defer a portion of A's gain from the sale of the QSB stock. A must recognize gain, however, to the extent that A's amount realized on the sale of the QSB stock, \$6,000, exceeds the cost of the replacement QSB stock purchased by A during the 60-day period beginning on the date of the sale of the QSB stock, \$5,500. Accordingly, A must recognize \$500 of the gain from the sale of the QSB stock. A defers recognition of the remaining \$3,000 of gain to the extent that such gain does not exceed the distribution nonrecognition limitation under paragraph (e)(3) of this section.

(iii) Under paragraph (e)(3)(i) of this section, A's nonrecognition limitation with respect to the sale of the QSB stock is A's section 1045 amount realized with respect to the stock, reduced by A's section 1045 adjusted basis with respect to the stock. A's amount realized from the sale is the product of A's amount realized from the sale, \$6,000; and a fraction—

(1) The numerator of which is A's smallest percentage interest in PRS capital with respect to such stock, 50 percent; and

(2) The denominator of which is A's percentage interest in that type of partnership QSB stock immediately after the distribution, 75 percent (the value of the stock distributed to A, \$3,000, divided by the value of all QSB stock of that type acquired by PRS, \$4,000).

(iv) Therefore, A's section 1045 amount realized is \$4,000 (\$6,000 multiplied by 50/75). Because PRS distributed the QSB stock to A in liquidation of A's interest in PRS, A's section 1045 adjusted basis is the product of PRS' basis in all of the QSB stock of the type distributed, \$3,000; A's smallest percentage interest in PRS capital with respect to QSB stock of the type distributed, 50 percent; and the percentage of the distributed QSB stock that was sold by A, 100 percent. Therefore, A's section 1045 adjusted basis is \$1,500 (the product of \$3,000, 50 percent, and 100 percent) and A's nonrecognition limitation amount on the sale of the QSB stock is \$2,500 (\$4,000 section 1045 amount realized minus \$1,500 section 1045 adjusted basis). Accordingly, A defers recognition of \$2,500 of the remaining \$3,000 gain from the sale of the QSB stock and must recognize \$500 of the remaining \$3,000 gain. Accordingly, A's total gain recognized from the sale of the QSB stock is \$1,000.

(v) A's basis in the replacement QSB stock is \$3,000 (cost of the replacement QSB stock, \$5,500, reduced by the gain not recognized under section 1045, \$2,500).

Example 11. Sale by partner of QSB stock received in a nonliquidating distribution. (i) The facts are the same as in *Example 10*, except that, on June 1, 2011, PRS distributes only \$2,000 of the QSB stock

to A, reducing A's interest in PRS capital from 60 percent to 33 percent. PRS' basis in the distributed QSB stock is \$1,500. On November 1, 2011, A sells for \$2,500 the QSB stock distributed by PRS to A and purchases, within 60 days of the date of sale of the QSB stock, replacement QSB stock for \$2,500. A makes a timely election to apply section 1045 with respect to A's sale of the distributed QSB stock.

(ii) Under section 732, A's basis in the distributed QSB stock is \$1,500. Therefore, A realizes a gain on the sale of the distributed QSB stock of \$1,000. Because A made an election to apply section 1045 to the sale, and because A purchased, within 60 days of A's sale of the QSB stock, replacement QSB stock at a cost equal to the amount realized on the sale of the distributed QSB stock, A defers recognition of the gain from the sale of the QSB stock to the extent that such gain does not exceed the distribution nonrecognition limitation.

(iii) Under paragraph (e)(3) of this section, the nonrecognition limitation with respect to A's sale of the QSB stock is A's section 1045 amount realized reduced by A's section 1045 adjusted basis. Because PRS did not distribute all of the particular type of QSB stock and the distribution of the QSB stock to A was not in liquidation of A's interest in PRS, under paragraph (e)(3)(ii)(C) of this section A's section 1045 amount realized is \$1,250 (A's amount realized from the sale of the distributed QSB stock, \$2,500, multiplied by A's smallest percentage interest in PRS capital with respect to such stock, 50 percent). Under paragraph (e)(3)(iii)(B) of this section, A's section 1045 adjusted basis is the product of the partnership's basis in the QSB stock sold by the partner, \$1,500, and A's smallest percentage interest in the partnership capital with respect to such stock, 50 percent. Therefore, A's section 1045 adjusted basis is \$750 (50 percent of \$1,500), and A's nonrecognition limitation amount on the sale of the QSB stock is \$500 (\$1,250 section 1045 amount realized minus \$750 section 1045 adjusted basis). As this amount is less than the amount of gain that A is eligible to defer under section 1045, \$1,000, A defers recognition of only \$500 of the gain from the sale of the QSB stock. A must recognize the remaining \$500 of that gain.

(iv) A's basis in the replacement QSB stock is \$2,000 (cost of the replacement QSB stock, \$2,500, reduced by the gain not recognized under section 1045, \$500).

Example 12. Contribution of replacement QSB stock to a partnership. (i) On January 1, 2008, A, an individual, B, an individual, and X, a C corporation, form PRS, a partnership. A, B, and X each contribute \$250 to PRS and agree to share all partnership items equally. On February 1, 2008, PRS purchases QSB stock for \$750. PRS sells the QSB stock on November 3, 2008, for \$1,050. PRS realizes \$300

of gain from the sale of the QSB stock (none of which is treated as ordinary income) and allocates \$100 of gain to each of its partners. PRS informs the partners that it does not intend to make an election under section 1045 with respect to the sale of the QSB stock. Each partner's share of the amount realized from the sale of the QSB stock is \$350. On November 30, 2008, A, an eligible partner within the meaning of paragraph (g)(3) of this section, purchases replacement QSB stock for \$350 and makes a section 1045 election under paragraph (c)(1) of this section. Subsequently, A transfers the replacement QSB stock to ABC, a partnership, in exchange for an interest in ABC.

(ii) Because A purchased within 60 days of PRS's sale of the QSB stock, replacement QSB stock for a cost equal to A's share of the partnership's amount realized on the sale of the QSB stock, and because A made a valid election to apply section 1045 with respect to A's share of the gain from PRS's sale of the QSB stock, A does not recognize A's \$100 distributive share of the gain from PRS's sale of the QSB stock. Before the contribution of the replacement QSB stock to ABC, A's adjusted basis in the replacement QSB stock is \$250 (\$350 cost minus \$100 nonrecognition amount). A does not recognize gain upon the contribution of QSB stock to ABC under section 721(a). Upon the contribution of the replacement QSB stock to ABC, A's basis in the ABC partnership interest is \$250, and ABC's basis in the replacement QSB stock is \$250. However, the replacement QSB stock does not qualify as QSB stock in ABC's hands. Neither A nor ABC will be eligible to defer gain under section 1045 on a subsequent sale of the replacement QSB stock.

(j) *Effective/applicability date—In general.* This section applies to sales of QSB stock on or after August 14, 2007.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 3. The authority citation for part 602 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805.

Par. 4. In §602.101 paragraph (b) is amended by adding in numerical order, §1.1045-1, to read as follows:

§602.101 OMB Control numbers.

* * * * *
(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.1045-1	1545-1893
* * * * *	

Kevin M. Brown,
*Deputy Commissioner for
Services and Enforcement.*

Eric Solomon,
*Assistant Secretary of
the Treasury (Tax Policy).*

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