

Notice of Proposed Rulemaking and Notice of Public Hearing

Section 1045 Application to Partnerships

REG-150562-03

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed 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 and deferral of gain on a partner's sale of qualified small business stock distributed by a partnership. The proposed regulations affect partnerships that invest in qualified small business stock and their partners. This document also provides notice of a public hearing on the proposed regulations.

DATES: Written or electronic comments and requests to speak and outlines of topics to be discussed at the public hearing scheduled for Tuesday, November 2, 2004, at 10 a.m. must be received by October 11, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-150562-03), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-150562-03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington DC, or sent electronically, via the IRS Internet site at: www.irs.gov/regs or via the Federal eRulemaking Portal at www.regulations.gov (IRS and REG-150562-03). The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Charlotte Chyr, (202) 622-3070, or Jian H. Grant, (202) 622-3050; concerning submissions, the hearing, and/or placement on the building access list to attend the hearing, Sonya Cruse, (202) 622-4693 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent 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, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP Washington, DC 20224. Comments on the collection of information should be received no later than September 13, 2004. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information can be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information in this proposed regulation is in §1.1045-1(b)(4)(ii). This information

is required to inform the IRS of partnerships and partners making the section 1045 election. The collection of information is required to obtain a benefit, that is, to elect to apply section 1045 treatment for qualified small business stock that is sold by the partnership. This information will be used by the partner to permit the partner to defer its allocable share of gain on the partnership's sale of qualified small business stock and by partnerships to make necessary adjustments to the basis of replacement qualified small business stock. The likely respondents are individuals, businesses or other for-profit institutions, and small businesses or organizations.

The estimated burden for the collection of information in §1.1045-1(b)(4)(ii) is as follows:

Estimated total annual reporting burden: 1,000 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: 1000

Estimated annual frequency of responses: On occasion

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

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

Background

Section 1045 and section 1202 both provide for special treatment of gain on the sale of QSB stock held by non-corporate taxpayers. Under section 1202 of the Internal Revenue Code (Code), a taxpayer other than a corporation (a non-corporate taxpayer) excludes 50 percent of gain on the sale of qualified small business (QSB) stock (as defined in section 1202(c)) from gross income if the taxpayer holds the stock for more than five years. Section

1045 permits a non-corporate taxpayer that holds QSB stock (relinquished QSB stock) for more than six months and sells it after August 5, 1997, to elect to defer recognizing gain 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 relinquished QSB stock. Any gain not recognized reduces the cost basis of the replacement QSB stock. Section 1045(b)(3). The taxpayer recognizes gain to the extent the amount realized on the sale of the relinquished QSB stock exceeds the cost basis of the replacement QSB stock. Section 1045(a). Section 1045 does not apply to any gain treated as ordinary income. *Id.*

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, (the 1998 Act) added section 1045(b)(5). That section provides that rules similar to the rules in section 1202(f), (g), (h), (i), (j), and (k) apply for purposes of section 1045. The legislative history accompanying the 1998 Act provides that the benefit of deferred recognition of gain with respect to the sale of QSB stock by a partnership will flow through to a partner who is not a corporation if the partner held the partnership interest at all times the partnership held the QSB stock. See H.R. Conf. Rep. 105-599, 105th Cong., 2d Sess. 339 (1998). The legislative history further provides that there are no limitations on the types of partners that a partnership may have in order for the benefits of section 1045 to apply. *Id.* at 340.

Under section 1202(g), a non-corporate taxpayer applies section 1202 to the taxpayer's share of a passthrough entity's gain from the sale of QSB stock if two requirements are met. First, the passthrough entity must have held the QSB stock for more than five years. Second, the taxpayer must have held an interest in the passthrough entity on the date the passthrough entity acquired the QSB stock and at all times thereafter before the disposition of the stock. For purposes of section 1202, passthrough entities include partnerships, S corporations, regulated investment companies (RICs), and common trust funds. Section 1202(g)(4).

QSB stock must generally be acquired by the taxpayer at its original issue. How-

ever, section 1202(h) provides that, in the case of certain transfers of QSB stock, the transferee is treated as having acquired such stock in the same manner as the transferor and as having held such stock during any continuous period immediately preceding the transfer during which it was held by the transferor. Section 1202(h) applies to transfers from a partnership to a partner of stock with respect to which requirements similar to the requirements of section 1202(g) are met at the time of the transfer (without regard to the 5-year holding period requirement) as well as to transfers by gift or at death.

The committee reports underlying the enactment of section 1202 explain that, under section 1202(h),

[q]ualified small business stock ... may be distributed by a partnership to one or more of its partners, as long as (1) all eligibility requirements with respect to qualified small business stock are met, and (2) the partner held its interest in the partnership on the date the partnership acquired the stock and at all times thereafter and before the disposition of the stock. In addition, a partner cannot treat stock distributed by a partnership as qualified small business stock to the extent that the partner's share of the stock distributed by the partnership exceeded the partner's interest in the partnership at the time the partnership acquired the stock.

H. R. Rep. No. 103-111, 103d Cong., 1st Sess. 602 (1993).

The committee report goes on to explain that transferees in cases not described in section 1202(h) are not eligible for partial exclusion of gain under section 1202(a). Thus, for example, if qualified small business stock is transferred to a partnership and the partnership disposes of the stock, any gain from the disposition will not be eligible for the exclusion. *Id.*

Rev. Proc. 98-48, 1998-2 C.B. 367, generally provides procedures for taxpayers (including passthrough entities and individuals holding interests in a passthrough entity) to elect to apply section 1045. The background section of the revenue procedure explains that, under section 1045(b)(5), a passthrough entity that sells QSB stock held for more than 6 months may make a section 1045 election

if the entity purchases replacement QSB stock during the 60-day period beginning on the date of the sale. Section 2.03, Rev. Proc. 98-48. The benefit of the section 1045 election flows through to a non-corporate taxpayer that held an interest in the passthrough entity for as long as the entity held the QSB stock. The background section of the revenue procedure also explains that, under section 1045(b)(5), if a passthrough entity sells QSB stock held for more than six months, a non-corporate taxpayer who has held an interest in the entity during the period in which the entity held the QSB stock and who purchases replacement QSB stock during the 60-day statutory period may elect to apply section 1045 to the non-corporate taxpayer's share of any gain on the sale that the entity does not defer under section 1045. Section 2.03, Rev. Proc. 98-48.

Since Rev. Proc. 98-48 was published, the IRS and Treasury Department have received inquiries regarding the application of section 1045 to partnerships and their partners. In response to these inquiries, the proposed regulations provide rules relating to sales and purchases of interests in a partnership that owns QSB stock, partnership dispositions of QSB stock, partnership distributions of QSB stock, and contributions of QSB stock to a partnership. Partners and partnerships wishing to elect section 1045 must continue to follow the procedures of Rev. Proc. 98-48 for rules regarding the time and manner for making the election, the scope of the election, and revocation of the election.

Explanation of Provisions

A. General Rules and Definitions

1. QSB stock

Section 1045(b)(1) provides that the term *QSB stock* has the same meaning given such term by section 1202(c). Section 1202(c) provides that the term *QSB stock* is any stock in a C corporation that is originally issued after the date of the enactment of the Revenue Reconciliation Act of 1993, if (A) as of the date of issuance, the corporation is a qualified small business, and (B) except as provided in section 1202(f) and (h), the stock is acquired by the taxpayer at its original issue in exchange for money or other property

(not including stock), or as compensation for services provided to the corporation.

Some taxpayers have asked if a partner may treat a sale of a partnership interest as a sale of QSB stock or an acquisition of a partnership interest as an acquisition of QSB stock. Sections 1045 and 1202 do not adopt a look-through approach to the sale and acquisition of partnership interests. Under the plain language of section 1202(c), an investment in a partnership that holds or purchases QSB stock is not treated as an investment in QSB stock. This plain language interpretation is further supported by the structure of sections 1045 and 1202. Congress clearly contemplated partnership transactions when enacting section 1202, as several of its provisions address such transactions. In light of this, Congress's failure to provide for section 1202(a) treatment for acquisitions and dispositions of partnership interests appears to have been intentional. Such a decision by Congress would be consistent with the approach taken by section 1202(g). That section allows partners to qualify for section 1202(a) treatment with respect to gain recognized by reason of holding a partnership interest only if the partner held the interest in the partnership on the date of the partnership's acquisition of QSB stock and at all times thereafter before the disposition of the stock by the partnership. If a partner were to sell its partnership interest while the partnership still held QSB stock, then the partner would not have held the partnership interest from the date of the acquisition of that stock until the date of the disposition of the stock by the partnership. For these reasons, the proposed regulations provide that the term *QSB stock* does not include an interest in a partnership that holds or purchases QSB stock.

2. Eligible partner

Under the proposed regulations, only an eligible partner may defer gain recognized by a partnership on the sale of QSB stock. Consistent with section 1202(g) and (h), the proposed regulations define an eligible partner as a non-corporate partner who held an interest in the partnership at all times that the partnership held the QSB stock or a non-corporate partner who acquired an interest in a partnership from an existing eligible partner by gift or death.

The proposed regulations provide special rules for determining eligible partners if a partnership (upper-tier partnership) holds an interest in a partnership (lower-tier partnership) that holds QSB stock. The proposed rules disregard the upper-tier partnership's ownership of the lower-tier partnership and treat each partner of the upper-tier partnership as owning the interest in the lower-tier partnership directly. A partner of the upper-tier partnership is treated as owning an interest in the lower-tier partnership during the period in which both the partner of the upper-tier partnership held an interest in the upper-tier partnership and the upper-tier partnership held an interest in the lower-tier partnership.

The IRS and the Treasury Department are concerned that, although the current look-through treatment for tiered partnerships may be the simplest approach, the application of the proposed rules presents the following potential problems: (1) the proposed rules prohibit an upper-tier partnership from making a section 1045 election at the partnership level; (2) the eligible partners of the upper-tier partnership may not have the necessary information to benefit from the proposed rules; and (3) notification from the lower-tier partnership to the upper-tier partnerships and their partners and vice versa may be difficult if multiple tiers of partnerships are involved. Accordingly, the IRS and Treasury Department request comments specifically on the application of the proposed rules with respect to tiered partnerships.

3. Nonrecognition limitation

Under the proposed regulations, the amount of gain that an eligible partner may defer under section 1045 (whether the election to apply section 1045 is made at the partnership or the partner level) may not exceed: (A) the partner's smallest percentage interest in the partnership's income, gain, or loss with respect to the relinquished QSB stock, multiplied by (B) the partnership's realized gain from the sale of such stock. For this purpose, the partnership's realized gain from the sale of the QSB stock is determined without regard to any basis adjustment under section 734(b) or 743(b). This 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 relinquished QSB stock.

B. Partnership Election Under Section 1045

1. General rule

Consistent with Rev. Proc. 98-48, the proposed regulations allow a partnership to elect to apply section 1045 if the partnership held QSB stock for more than six months, sold such QSB stock, and purchased other QSB stock (replacement QSB stock) within 60 days of the sale. If the partnership makes an election under section 1045, all eligible partners of the partnership must defer their distributive shares of the partnership section 1045 gain from the partnership's sale of the QSB stock. No separate election is required of the partners. Partnership section 1045 gain equals the partnership's gain from the sale of the QSB stock reduced by the greater of: (A) the gain from the sale of the QSB stock that is treated as ordinary income, or (B) the excess of the amount realized by the partnership on the sale over the cost of any replacement QSB stock purchased by the partnership during the 60-day period beginning on the date of the sale.

2. Election procedures and notification

The proposed regulations require the partnership to make the section 1045 election on the partnership's timely filed return (including extensions) for the taxable year during which the partnership sells the QSB stock. In addition, the partnership must follow the procedures of Rev. Proc. 98-48.

When a partnership makes the election, the proposed regulations require the partnership to notify all partners that it has made the election, and separately state each partner's distributive share of the partnership section 1045 gain under section 702. Each partner must determine if it is an eligible partner and report the partner's distributive share of gain, including gain not recognized, on Schedule D of the partner's federal income tax return.

1. General rule

Also consistent with Rev. Proc. 98-48, the proposed regulations allow an eligible partner to make a section 1045 election with respect to the partner's share of gain from the partnership's sale of QSB stock if the partnership does not make a section 1045 election or purchase replacement QSB stock within the statutory time period. The election may be made if the partnership either replaces none of the relinquished QSB stock or replaces some but not all of the relinquished QSB stock. For example, relinquished QSB stock can be partially replaced by the partnership and partially replaced by the partner if section 1045 elections are made by both the partnership and the partner. If a partner makes a section 1045 election, the partner recognizes its distributive share of the gain from the sale of the relinquished QSB stock only to the extent of the greater of: (1) the gain that is treated as ordinary income, or (2) the excess of the partner's share of the amount realized by the partnership on the sale of the QSB stock over the cost of any replacement QSB stock purchased by the partner during the 60-day statutory period.

A partnership that has sold QSB stock should promptly notify its partners when it does not intend to make a section 1045 election with respect to the sale. Prompt notification will allow partners who intend to make separate section 1045 elections time to purchase replacement QSB stock within 60 days of the sale of the relinquished QSB stock and to make timely section 1045 elections. However, the proposed regulations do not impose a requirement on partnerships to provide such notification. The IRS and Treasury Department believe that it is more appropriate for the partners to decide (for example, in the partnership agreement) whether, and to what extent, the partnership must provide such notification.

2. Election procedures

The proposed regulations provide 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. In addition, the partner must follow the procedures of Rev. Proc. 98-48.

D. Basis Adjustments

The proposed regulations provide rules regarding adjustments to the eligible partner's basis in the partnership interest and the partnership's basis in the replacement QSB stock. Under these rules, if the partnership makes a section 1045 election, then the eligible partner may not increase its outside basis by the amount of gain that is not recognized under section 1045. In addition, the partnership is required to reduce its basis in the replacement QSB stock by the amount of gain that is not recognized by its partners. The adjustment to the partnership's inside basis in the replacement QSB stock is similar to a basis adjustment under section 743(b). These rules are necessary to preserve (in the replacement QSB stock and the partnership interest) the deferred gain on the sale of the relinquished QSB stock.

As explained above, a partner's basis in a partnership interest is not increased by any gain that is deferred by reason of a *partnership* section 1045 election. In contrast, a partner's basis in a partnership interest is increased by any gain that is deferred by reason of a *partner* section 1045 election. A partner must reduce the basis of any replacement QSB stock the partner purchases by the amount of gain that is not recognized by reason of a *partner* section 1045 election.

To allow the partnership to make the appropriate adjustments to the basis of the replacement QSB stock, the proposed regulations require any partner who recognizes all or 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. In the absence of notification, the partnership must presume that the partner deferred recognition of the partnership section 1045 gain and decrease its basis in the replacement QSB stock by the partner's distributive share of partnership section 1045 gain until such time as the partner provides notification of the amount recognized by the partner. However, if the partnership knows that one of its partners was, during any period in which the partner

held the QSB stock, classified as a corporation for federal tax purposes, then the partnership may presume that the partner did not defer recognition of the partnership section 1045 gain even in the absence of a notification by the partner.

E. Distribution of QSB Stock

Consistent with section 1202(h) and the legislative history underlying that section, the proposed regulations provide that, if a partnership distributes QSB stock to an eligible partner, then the eligible partner is treated as having acquired such stock in the same manner as the partnership and having held such stock during any continuous period immediately preceding the distribution during which it was held by the partnership. However, the amount of gain on the sale of such distributed QSB stock that the partner can defer cannot exceed the distribution nonrecognition limitation. For this purpose, the distribution nonrecognition limitation is equal to the partner's section 1045 amount realized, reduced by the partner's section 1045 adjusted basis. The proposed regulations provide rules for determining the partner's section 1045 amount realized and the partner's section 1045 adjusted basis in the case of a liquidating distribution, a nonliquidating distribution of all of the QSB stock (of the same type), and other nonliquidating distributions.

These rules follow the legislative history's directive that a partner may not treat stock distributed by a partnership as QSB stock to the extent that the partner's share of the distributed stock exceeds the partner's interest in the partnership at the time the partnership acquired the stock. Under the proposed regulations, the amount of gain that a distributee partner may defer on the sale of distributed QSB stock will be no more than (but in the case of QSB stock received in certain nonliquidating distributions may be less than) the amount of gain that the partner would have been able to defer in the absence of the distribution.

The IRS and Treasury Department considered an alternative approach for determining the distribution nonrecognition limitation for sales of QSB stock following a nonliquidating distribution to a partner. Under this alternative approach, the distribution nonrecognition limitation would be determined by reference to the

maximum amount of gain that the partner would have been able to defer if the partnership had not distributed any QSB stock of the type sold, but instead had sold all of that QSB stock for a per share price equal to the per share price received on the actual sale of the distributed QSB stock by the partner. Due to the complexity of this alternative approach, it was rejected and is not included in the proposed regulations. The IRS and Treasury Department request comments on the extent to which refinements of the distribution nonrecognition limitation applicable to sales of distributed QSB stock are appropriate.

F. Contribution of QSB Stock

The proposed regulations provide that a contribution of QSB stock to a partnership in a transaction to which section 721(a) applies does not cause the contributing partner to recognize any gain that was previously deferred under section 1045. However, the QSB stock, once contributed, is no longer QSB stock in the hands of the partnership because the partnership has not acquired the stock at original issue within the meaning of section 1202(c)(1)(B). See also H.R. Rep. No. 103–111, 103d Cong., 1st Sess. 602 (1993).

G. Proposed Effective Date

The regulations are proposed to apply to sales of QSB stock on or after the date final regulations are published in the **Federal Register**.

Effect on Other Documents

The following publication will be amplified for partners and partnerships beginning on or after the date these regulations are published as final regulations in the **Federal Register**:

Rev. Proc. 98–48, 1998–2 C.B. 367.

Special Analyses

It has been determined that this notice of proposed rulemaking 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, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Tuesday, November 2, 2004, at 10 a.m. in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, D.C. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the “FOR FURTHER INFORMATION CONTACT” section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by October 11, 2004. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed.

Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these regulations are Charlotte Chyr and Jian H. Grant, Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

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) *General rules*—(1) *Definition of QSB stock*—*In general.* For purposes of section 1045 and this section, *qualified small business stock* (QSB stock) has the meaning provided in section 1202(c). For purposes of section 1045 and this section, the term *QSB stock* does not include an interest in a partnership that purchases or holds QSB stock. (For further guidance, see *Example 1* and *Example 2* of paragraph (g) of this section.)

(2) *Eligible partner*—(i) *In general.* For purposes of this section, an eligible partner with respect to QSB stock is a taxpayer other than a corporation who holds an interest in a partnership on the date the partnership acquires the QSB stock and at all times thereafter before the partnership sells or distributes the QSB stock.

(ii) *Acquisition by gift or at death.* For purposes of this section, a taxpayer who acquires from an eligible partner 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 eligible partner held the interest in the partnership. (For further guidance, see *Example 6* of paragraph (g) of this section.)

(iii) *Tiered partnership*—(A) *Generally*. If a partnership (upper-tier partnership), holds an interest in another partnership (lower-tier partnership) that holds QSB stock, then, for purposes of this paragraph (a)(2), the upper-tier partnership's ownership of the lower-tier partnership is ignored 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—

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

(2) The upper-tier partnership held an interest in the lower-tier partnership. (For further guidance, see *Example 3* of paragraph (g) of this section.)

(B) *Multiple tiers of partnership*. Principles similar to those described in paragraph (a)(2)(iii)(A) of this section apply where a taxpayer holds the interest in the lower-tier partnership through multiple tiers of partnerships.

(3) *Nonrecognition limitation*—(i) *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. For this purpose, the nonrecognition limitation is equal to the product of—

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

(B) The eligible partner's smallest percentage interest in the partnership's income, gain, or loss with respect to the QSB stock that was sold. (For further guidance, see *Example 4* of paragraph (g) of this section.)

(ii) *Eligible partner's smallest percentage interest*. In determining an eligible partner's smallest percentage interest in the partnership's income, gain, or loss with respect to QSB stock, reductions in the partner's interest that occur solely as a result of a distribution of QSB stock to the partner are not taken into account.

(b) *Partnership election*—(1) *General rule*. A partnership that holds QSB stock for more than six months, sells such QSB

stock, and purchases other QSB stock (replacement QSB stock), within 60 days beginning on the date of the sale may elect to apply section 1045. For purposes of this paragraph (b)(1), a purchase of replacement QSB stock by a partner is not treated as a purchase of replacement QSB stock by the partnership. If the partnership elects to apply section 1045, then, subject to the provisions of paragraph (a)(3) of this section, each eligible partner does not recognize the partner's distributive share of any partnership section 1045 gain. 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 cost of any replacement QSB stock purchased by the partnership during the 60-day period beginning on the date of the sale (excluding the cost of any replacement QSB stock that is otherwise taken into account under section 1045).

(2) *Partner's share of partnership section 1045 gain*. A partnership must allocate partnership section 1045 gain to the partners in the same proportion as the partnership's entire gain from the sale of the QSB stock is allocated to the partners. 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*. Notwithstanding section 705(a)(1), the adjusted basis of a partner's interest in a partnership is not increased by gain from a partnership's sale of QSB stock that is not recognized by the partner under paragraph (b)(1) of this section.

(ii) *Partnership's replacement QSB stock*. 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. 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). For purposes of this paragraph (b)(3)(ii), the partnership must presume that a partner did not recognize that partner's distributive share of QSB gain until such time as the partner provides to the partnership the notification described in paragraph (b)(4)(ii) of this section. However, if the partnership knows that a particular partner is classified, for Federal tax purposes, as a corporation during any period in which the partnership held the QSB stock, then the partnership may presume that the partner did not defer recognition of the partnership section 1045 gain, even in the absence of a notification by the partner.

(4) *Notice requirements*—(i) *Partnership notification to partners*. A partnership that makes the election described in paragraph (b)(1) of this section must notify all of its partners of the election in accordance with the applicable forms and instructions and separately state each partner's distributive share of gain from the sale of QSB stock under section 702. Each partner shall determine whether the partner is an eligible partner within the meaning of paragraph (b)(1) of this section and report the partner's distributive share of gain from the partnership's sale of QSB stock, including gain not recognized, on Schedule D of the partner's federal income tax return.

(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. (For further guidance concerning paragraph (b) of this section, see *Example 4* through *Example 7* of paragraph (g) of this section.)

(c) *Partner election*—(1) *In general*. If an eligible partner of a partnership that sells QSB stock purchases replacement QSB stock during the 60-day period beginning on the date of the partnership's sale of the QSB stock, then the partner may elect to apply section 1045. For purposes of this paragraph (c)(1), a purchase of replacement QSB stock by the partnership is not treated as a purchase of replacement QSB stock by a partner. An eligible partner that elects to apply section

1045 must recognize its distributive share of gain from the partnership's sale of QSB stock only to the extent of the greater of—

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

(ii) The excess of the partner's share of the amount realized by the partnership on the sale of the QSB stock (excluding any QSB stock that was replaced by the partnership) over the cost of any replacement QSB stock purchased by the partner during the 60-day period beginning on the date of the partnership's sale of the QSB stock (excluding the cost of any replacement QSB stock that is otherwise taken into account under section 1045).

(2) *Partner's share of amount realized by partnership.* The partner's share of the amount realized by the partnership shall bear the same proportion to the amount realized by the partnership on the sale of the QSB stock (excluding the cost of any replacement QSB stock) as the partner's distributive share of the partnership's realized gain from the sale of the QSB stock bears to the partnership's realized gain on the sale of the QSB stock. For this purpose, the partnership's realized 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.* Under section 705(a)(1), the adjusted basis of a partner's interest in a partnership is increased by the amount of gain that is not recognized by an eligible partner pursuant to paragraph (c)(1) of this section.

(ii) *Partner's replacement QSB stock.* A partner's basis in any replacement QSB stock that is purchased by the partner during the 60-day period described in paragraph (c)(1) of this section must be reduced (in the order acquired) by the partner's distributive share of the gain on the sale of the partnership's QSB stock that is not recognized by the partner pursuant to paragraph (c)(1) of this section. (For further guidance concerning this paragraph (c), see *Example 8* through *Example 10* of paragraph (g) of this section.)

(d) *Partnership distribution of QSB stock to an eligible partner*—(1) *In general.* Subject to paragraphs (d)(2) and (3)

of this section, in the case of a partnership distribution of QSB stock to an eligible partner within the meaning of paragraph (a)(2) of this section, the eligible partner shall be treated 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. (For further guidance concerning this paragraph (d), see *Example 11* and *Example 12* of paragraph (g) of this section.)

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

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

(A) The partner's section 1045 amount realized; reduced by

(B) The partner's section 1045 adjusted basis.

(ii) *Section 1045 amount realized*—(A) *QSB stock received in liquidation of partner's interest and in certain nonliquidating distributions.* If a partner receives relinquished 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 relinquished QSB stock, multiplied by a fraction—

(1) The numerator of which is the partner's smallest percentage interest (prior to the distribution) in the partnership's income, gain, or loss with respect to the type of QSB stock sold by the partner; and

(2) The denominator of which is the partner's percentage interest in that type of partnership QSB stock immediately after

the distribution (determined under paragraph (d)(3)(iv) of this section).

(B) *QSB stock received in other distributions.* If a partner receives relinquished QSB stock in a distribution from the partnership that is not described in paragraph (d)(3)(ii)(A) of this section, the partner's section 1045 amount realized is the partner's amount realized from the sale of the relinquished QSB stock multiplied by the partner's smallest interest (prior to the distribution) in the partnership's income, gain, or loss with respect to such stock.

(iii) *Section 1045 adjusted basis*—(A) *QSB stock received in liquidation of partner's interest and in certain nonliquidating distributions.* If a partner receives relinquished 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 743(b), other than basis adjustments described in paragraph (b)(3)(ii) of this section);

(2) The partner's smallest interest (prior to the distribution) in the partnership's income, gain, or loss with respect to such stock; 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 relinquished QSB stock in a distribution from the partnership that is not described in paragraph (d)(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 743(b), other than basis adjustments described in paragraph (b)(3)(ii) of this section); and

(2) The partner's smallest interest (prior to the distribution) in the partnership's income, gain, or loss with respect to such stock.

(iv) *Partner's percentage interest in distributed QSB stock.* For purposes of this paragraph (d)(3), a partner's percentage interest in a type of QSB stock immedi-

ately 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 (d)(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 its original issue.

(e) *Contribution of QSB stock or replacement QSB stock to a partnership.* Section 721 applies to a contribution of QSB stock to a partnership by a taxpayer other than a corporation. 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 in the hands of the taxpayer. Stock that is contributed to a partnership is not QSB stock in the hands of the partnership because the partnership did not acquire the stock at original issue. (For further guidance, see *Example 13* of paragraph (g) of this section.)

(f) *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) 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 under section 706. In addition, a partnership or partner making an election under section 1045 must follow the administrative procedures issued for making such elections. (For further guidance, see Rev. Proc. 98-48, 1998-2 C.B. 367, and §601.601(d)(2)(ii)(b) of this chapter.)

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

Example 1. Acquisition of a partnership interest as replacement property. On January 1, 2006, A, an individual, X, a corporation, and Y, a corpo-

ration, form PRS, a partnership. A, X, and Y each contribute \$25 to PRS and agree to share all partnership items equally. PRS purchases QSB stock on February 1, 2006, and subsequently sells the QSB stock on November 4, 2006, for \$150. PRS realizes \$75 of gain from the sale of the QSB stock (none of which is treated as ordinary income) and allocates \$25 of gain to each of A, X, and Y. On November 30, 2006, A contributes \$50 to ABC, a partnership, in exchange for an interest in ABC (instead of purchasing QSB stock). ABC then purchases QSB stock for \$50 on December 1, 2006. A's acquisition of the additional partnership interest is not treated as a purchase of replacement QSB stock for purposes of section 1045.

Example 2. Sale of a partnership interest. The facts are the same as in *Example 1*, except that PRS does not sell its QSB stock. Instead, on November 4, 2006, A sells the PRS interest for \$50x, realizing \$25 of capital gain. On November 30, 2006, A purchases \$50 of new QSB stock. Under paragraph (a)(1) of this section, the sale of an interest in a partnership that holds QSB stock is not treated as a sale of QSB stock. Therefore, A may not elect to apply section 1045 with respect to A's \$25 of gain from the sale of the PRS interest.

Example 3. Eligible and non-eligible partners of tiered partnership. On January 1, 2006, A, an individual, and B, an individual, contribute cash to UTP, (upper-tier partnership) for equal partnership interests. On February 1, 2006, UTP and C, an individual, contribute cash to LTP, (lower-tier partnership) for equal partnership interests. On March 1, 2006, LTP purchases QSB stock. On April 1, 2006, D, an individual, joins UTP by contributing cash to UTP for a 1/3 interest in UTP. On December 1, 2006, LTP sells the QSB stock. Under paragraph (a)(2)(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 paragraph (a)(2)(i) of this section, A and B are eligible partners, and D is not an eligible partner.

Example 4. Partnership sale of QSB stock and purchase and sale of replacement QSB stock. (i) Assume the same facts as in *Example 1*, except that PRS purchases replacement QSB stock for \$135 on December 15, 2006. On its timely filed return for the taxable year during which the sale of the relinquished QSB stock occurs, PRS makes an election to apply section 1045. PRS knows that X and Y are corporations. On March 30, 2007, PRS sells the replacement QSB stock for \$165. PRS realizes \$30 of capital gain from the sale of the replacement QSB stock and allocates \$10 of gain to each of A, X, and Y.

(ii) Under paragraph (b)(1) of this section, the partnership section 1045 gain is \$60 (\$75 gain less \$15 (\$150 amount realized on the sale of the relinquished QSB stock less \$135 cost of the replacement QSB stock)). This amount must be allocated among the partners in the same proportions as the entire gain from the sale of the QSB stock is allocated to the partners, 1/3 (\$20) to A, 1/3 (\$20) to X, and 1/3 (\$20) to Y.

(iii) Because neither X nor Y are eligible partners under paragraph (a)(2) of this section, X and Y must each recognize its \$25 distributive share of partnership gain from the sale of the QSB stock. Because A is an eligible partner under paragraph (a)(2) of this section, and because A is bound by the election by

PRS to apply section 1045, A defers recognition of A's \$20 distributive share of partnership section 1045 gain. A is not required to separately elect to apply section 1045. A must recognize A's remaining \$5 distributive share of the partnership's gain from the sale of the QSB stock.

(iv) Under section 705(a)(1)(A), the adjusted bases of X's and Y's interests in PRS are each increased by \$25. Under section 705(a)(1)(A) and paragraph (b)(3)(i) of this section, the adjusted basis of A's interest in PRS is not increased by the \$20 of partnership section 1045 gain that was not recognized by A, but is increased by A's remaining \$5 distributive share of gain.

(v) PRS must decrease its basis in the replacement QSB stock by the \$20 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 the replacement QSB 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 sale of the replacement QSB stock in which A has a \$20 negative basis adjustment equals \$30 (A's share of PRS's gain from the sale of the replacement QSB stock (\$10), increased by the amount of A's negative basis adjustment for the replacement stock (\$20)). Accordingly, upon the sale of the replacement QSB stock, A recognizes \$30 of gain, and X and Y each recognize \$10 of gain.

Example 5. Sale of partnership interest while partnership holds QSB stock. Assume the same facts as in *Example 4*, except that A sells A's interest in PRS to B, an individual, on March 1, 2006. B is not an eligible partner under paragraph (a)(2)(i) of this section, because B did not hold an interest in PRS on the date PRS originally acquired the QSB stock. Therefore, B must recognize B's distributive share of partnership section 1045 gain.

Example 6. Death of partner while partnership holds QSB stock. Assume the same facts as in *Example 4*, except that A dies on March 1, 2006, and B inherits A's interest in PRS. Under paragraph (a)(2)(ii) of this section, B is treated as holding the interest in PRS during the period that A held the interest in PRS. Therefore, B is an eligible partner under paragraph (a)(2)(i) of this section. Accordingly, B defers recognition of B's distributive share of the partnership section 1045 gain on the sale of the QSB stock.

Example 7. Partnership sale of QSB stock and partner purchase of replacement QSB stock. (i) Assume the same facts as in *Example 4*, except that PRS does not make an election under section 1045 with respect to the sale of the QSB stock. On November 30, 2006, A, an eligible partner under paragraph (a)(2) of this section, purchases replacement QSB stock for \$50. A elects 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's gain from the sale of the relinquished QSB stock.

(ii) Under paragraph (c)(2) of this section, A's share of the amount realized from PRS's sale of the QSB stock is \$50 (the amount which bears the same proportion to the total amount realized by the partnership on the sale of the QSB stock (\$150) as A's share of the gain from the sale of the QSB stock (\$25) bears to the total gain realized by the partnership on the sale of the QSB stock (\$75)). 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, A defers recognition of A's \$25 distributive share of gain from PRS's sale of the QSB stock. Under section 705(a)(1) and paragraph (c)(3)(i) of this section, the adjusted basis of A's interest in PRS is increased by \$25. Under paragraph (c)(3)(ii) of this section, A's basis in the replacement QSB stock is \$25 (\$50 cost minus \$25 nonrecognition amount).

Example 8. Election by partner; replacement by partnership. Assume the same facts as in *Example 7*, except that PRS purchases replacement QSB stock on December 31, 2006, but does not make an election to apply section 1045. A makes an election to apply section 1045, but does not purchase any replacement QSB stock during the 60-day period beginning on the date of PRS's sale of the QSB stock. Because the requirements of neither paragraph (b)(1) nor paragraph (c)(1) of this section has been satisfied, A must recognize all of A's distributive share of the gain from PRS's sale of the QSB stock.

Example 9. Partial replacement by partnership; partial replacement by partner. (i) On January 1, 2006, A, an individual, and X, a corporation, form PRS, a partnership. A and X each contribute \$50 to PRS and agree to share all partnership items equally. PRS purchases QSB stock on February 1, 2006, for \$100 and subsequently sells the QSB stock on January 31, 2008, for \$300. PRS realizes \$200 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 A and X. On February 10, 2008, PRS purchases replacement QSB stock for \$220. On March 20, 2008, A purchases replacement QSB stock for \$40. Both A and PRS make valid elections to apply section 1045.

(ii) Under paragraph (b)(1) of this section, partnership section 1045 gain is \$120 (\$200 less \$80 (\$300 amount realized on the sale of the relinquished QSB stock minus \$220 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 (\$60), and $\frac{1}{2}$ to X (\$60). Because A is an eligible partner, A defers recognition of A's \$60 distributive share of partnership section 1045 gain.

(iii) A also made a valid section 1045 election and purchased, within 60 days of PRS's sale of the QSB stock, replacement QSB stock. 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, however, to the extent that A's share of the amount realized by PRS on the sale of the QSB stock (excluding 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 QSB stock that was replaced by PRS) is \$80 (\$300 minus \$220). Under paragraph (c)(2) of this section, A's share of that amount realized is \$40 (50/100 (A's share of the gain from the sale of the QSB stock) multiplied by \$80). Because the replacement QSB stock purchased by A cost \$40,

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 gain that was not recognized pursuant to paragraph (b)(1) of this section, \$60, but is increased by the gain that was not recognized pursuant to paragraph (c)(1) of this section, \$40. See paragraphs (b)(3)(i) and (c)(3)(i) of this section. PRS must decrease its basis in the replacement QSB stock by the \$60 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 \$40 not recognized pursuant to paragraph (c)(1) of this section. See paragraph (c)(3)(ii) of this section.

Example 10. Change in partner's interest in partnership while partnership holds QSB stock. (i) Assume the same facts as in *Example 9*, except that, on August 2, 2006, A sells a 25 percent interest in PRS to Z. On July 10, 2007, A repurchases the 25 percent interest from Z for \$50. Assume that PRS makes a timely election under section 754 for the taxable year during which A purchases Z's PRS interest and that, under section 743(b), A has a positive basis adjustment of \$25.

(ii) PRS allocates the \$200 of realized gain from the sale of the QSB stock \$100 to A and \$100 to X. However, A has a positive basis adjustment of \$25; therefore, A's share of the gain is reduced to \$75. Because A is an eligible partner under paragraph (a)(2) 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 (a)(3) of this section. The smallest interest that A held in PRS 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 \$200, A may defer recognition of \$50 (25% of \$200) of the gain from the sale of the QSB stock. A must recognize the remaining \$25 of that gain.

Example 11. Sale by partner of QSB stock received in a liquidating distribution. (i) On January 1, 2006, A, an individual, and X, a corporation, form PRS, a partnership. A and X each contribute \$150 to PRS and agree to share all partnership items equally. PRS purchases QSB stock on February 1, 2006, for \$300. On May 1, 2006, when the QSB stock has appreciated in value to \$400, A contributes \$100 to PRS, increasing A's interest in PRS's income, gains, losses, deductions, and credits to 60 percent. On June 1, 2009, when the QSB stock is still worth \$400, PRS makes a liquidating distribution of \$300 worth of QSB stock to A. Under section 732, A's basis in the distributed QSB stock is \$250. A sells the QSB stock on August 4, 2009, for \$600, realizing a gain of \$350 (none of which is treated as ordinary income). A purchases replacement QSB stock on August 30, 2009, for \$550, and makes a valid election under section 1045 with respect to the QSB stock.

(ii) A is an eligible partner under paragraph (a)(2)(i) of this section. Therefore, under paragraph (d)(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, 2006, 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, \$600, 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 relinquished QSB stock, \$550. Accordingly, A must recognize \$50 of the gain from the sale of the QSB stock. A defers recognition of the remaining \$300 of gain to the extent that such gain does not exceed the distribution nonrecognition limitation.

(iii) Under paragraph (d)(3)(ii) 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, \$600; and a fraction:

(1) the numerator of which is A's smallest percentage interest in PRS's income, gain, or loss with respect to such stock, 50%; and

(2) the denominator of which is A's percentage interest in that type of partnership QSB stock immediately after the distribution, 75% (the value of the stock distributed to A, \$300, divided by the value of all QSB stock of that type acquired by PRS, \$400).

Therefore, A's section 1045 amount realized is \$400 (\$600 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's basis in all of the QSB stock of the type distributed, \$300; A's smallest interest (prior to the distribution) in PRS's income, gain, or loss with respect to QSB stock of the type distributed, 50%; and the percentage of the distributed QSB stock that was sold by A, 100%. Therefore, A's section 1045 adjusted basis is \$150 (the product of \$300, 50%, and 100%) and A's nonrecognition limitation amount on the sale of the QSB stock is \$250 (\$400 section 1045 amount realized minus \$150 section 1045 adjusted basis). Accordingly, A defers recognition of \$250 of the remaining \$300 gain from the sale of the QSB stock.

(iv) A's basis in the replacement QSB stock is \$300 (cost of the replacement stock, \$550, reduced by the gain not recognized under section 1045, \$250).

Example 12. Sale by partner of QSB stock received in a nonliquidating distribution. (i) The facts are the same as in *Example 11*, except that, on June 1, 2009, PRS distributes only \$200 of the QSB stock to A, reducing A's interest in PRS from 60% to 33%. PRS's basis in the distributed QSB stock is \$150. On November 1, 2009, A sells for \$250 the QSB stock distributed by PRS to A and purchases, within 60 days of the date of sale of the relinquished QSB stock, replacement QSB stock for \$250. On December 1, 2009, PRS sells all of its QSB stock for \$250 and purchases, within 60 days of the date of the sale of the relinquished QSB stock, replacement QSB stock for \$250. A makes a timely election to apply section 1045 with respect to its sale of the distributed QSB stock and PRS makes a timely election to apply section 1045 with respect to its sale of the QSB stock.

(ii) Under section 732, A's basis in the distributed QSB stock is \$150. Therefore, A realizes a gain on the sale of the distributed QSB stock of \$100. Because A made a valid 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 (d)(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 a particular type of QSB stock and the distribution of the QSB stock to A was not in liquidation of A's interest in PRS, A's section 1045 amount realized is \$125 (A's amount realized from the sale of the distributed QSB stock, \$250, multiplied by A's smallest percentage interest (prior to the distribution) in PRS's income, gain, or loss with respect to such stock, 50%). A's section 1045 adjusted basis is the product of the partnership's basis in the QSB stock sold by the partner, \$150, and A's smallest percentage interest (prior to the distribution) in the partnership's income, gain, or loss with respect to such stock, 50%. Therefore, A's section 1045 adjusted basis is \$75 (50% of \$150), and A's nonrecognition limitation amount on the sale of the QSB stock is \$50 (\$125 section 1045 amount realized minus \$75 section 1045 adjusted basis). As this amount is less than the amount of gain that A is eligible to defer under section 1045, \$100, A defers recognition of only \$50 of the gain from the sale of the QSB stock. A must recognize the remaining \$50 of that gain.

(iv) The partnership realizes gain of \$100 (\$250 amount realized minus \$150 remaining basis in QSB stock) on the sale of its QSB stock. Because the partnership reinvested its entire amount realized in new QSB stock and because the partnership made a timely election to apply section 1045, the partnership may treat all of this gain as section 1045 gain. A's share of the partnership section 1045 gain is \$50 (50% of \$100). Because A is an eligible partner under paragraph (a)(2) of this section, A can defer recognition of this gain subject to the nonrecognition limitation described in paragraph (a)(3) of this section. The smallest percentage interest that A held in PRS during the time that PRS held the QSB stock (determined without regard to the reduction that occurred as a result of PRS's distribution of QSB stock to A) is 50%. See paragraph (a)(3)(ii) of this section. Therefore, under the nonrecognition limitation, A can defer recognition of all \$50 (50% of \$100) of the gain allocated to A.

Example 13. Contribution of replacement QSB stock to a partnership. (i) On January 1, 2006, A, an individual, B, an individual, and X, a corporation, form PRS, a partnership. A, B, and X each contribute \$25 to PRS and agree to share all partnership items equally. On February 1, 2006, PRS purchases Stock 1, which is QSB stock in the hands of the partnership. PRS sells Stock 1 on November 4, 2006, for \$150. PRS realizes \$75 of gain from the sale of Stock 1 (none of which is treated as ordinary income) and allocates \$25 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 Stock 1. Each partner's share of the amount realized from the sale of Stock 1 is \$50. On November 30, 2006, A, an eligible partner within the meaning of

paragraph (a)(2) of this section, purchases Stock 2, which is also QSB stock, for \$50 and makes a valid section 1045 election under paragraph (c)(1) of this section. Subsequently, A transfers Stock 2 to ABC, a partnership.

(ii) Because A purchased, within 60 days of PRS's sale of Stock 1, replacement QSB stock for a cost equal to A's share of the partnership's amount realized on the sale of Stock 1, 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 Stock 1, A does not recognize A's \$25 distributive share of the gain from PRS's sale of Stock 1. Before the contribution of Stock 2 to ABC, A's adjusted basis in Stock 2 is \$25 (\$50 cost minus \$25 nonrecognition amount). Upon the contribution of Stock 2 to ABC, A's basis in the ABC partnership interest is \$25, and ABC's basis in Stock 2 is \$25. However, Stock 2 does not qualify as QSB stock in ABC's hands because it was not acquired at original issue. Neither A nor ABC will be eligible for section 1045 treatment on a subsequent sale of Stock 2.

(h) *Effective date.* This section applies to sales of QSB stock on or after the date final regulations are published in the **Federal Register**.

Mark E. Matthews,
*Deputy Commissioner for
Services and Enforcement.*

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