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TY:

LEGEND:

Taxpayer (P1) =
AB =
CD =
CD-Inc =
Government Entity =
Blackacre =

X =
Y =
\$A =
\$B =
\$C =
\$D =
\$E =
\$F =
\$G =
\$H =
\$J =
\$K =
\$L =
X% =
Y% =
Z% =
Date 1 =
Date 2 =
County X =

Dear

This is in response to your request for a private letter ruling dated July 10, 2008, on the proper treatment of the reinvestment of condemnation proceeds under § 1033 of the Internal Revenue Code following the proposed division of a partnership under § 708 of the Code.

FACTS

AB, a limited partnership, and CD, a limited partnership, are equal general partners owning half interests in Taxpayer (P1), a general partnership. AB and CD each have a tax capital account of \$A in P1 and P1 has a recourse liability of \$B. AB and CD each has a basis of \$C in its P1 interest. P1's inside basis in its assets is equal to AB's and CD's total bases in their P1 interests.

P1 is engaged in business of farming on Blackacre. AB owns and operates other farming properties in addition to its partnership interest in P1. On the other hand, CD's sole asset is its partnership interest in P1, while its general partner, CD-Inc is also a general partner of one other farming partnership and of several commercial property (non-farming) partnerships.

On Date 1, P1 purchased Blackacre, a tract of land consisting of approximately X acres in County X, from a third party. On Date 2, the southern Y acres of Blackacre were acquired by Government Entity under threat of condemnation. P1 received approximately \$D for the Y acres. The basis of the Y acres in P1's hands was approximately \$E and the sales costs were approximately \$F. P1 has elected to defer the \$G gain from the sale of the Y acres under § 1033.

AB and CD disagreed about the selection of replacement property for the Y acres of farm land. AB felt that the proceeds should be used to acquire additional farming property while CD felt that P1 should diversify its investments and acquire non-farming investment property. After failing to agree on what to acquire for replacement property, AB and CD decided that both farming and non-farming replacement property would be acquired by separate continuing partnerships formed by P1 and that AB and CD would each control one of the partnerships, with the other owning a small interest in that partnership. CD and AB will continue as partners in P1 to farm the remaining acres held by P1.

P1 proposes to create two new partnerships, P2 and P3. AB will be the general partner in P2 and CD will be the general partner in P3. P1 will transfer approximately \$H of the proceeds from the sale of the Y acres of Blackacre, along with half of its obligation to acquire replacement property under § 1033, to P2 in exchange for a X% general partner interest in P2 and a Y% limited partner interest in P2. CD will contribute \$J to P2 in exchange for a Z% limited partner interest in P2. P1 will then distribute its general and limited partner interests in P2 to AB. P1 will also contribute \$H of the proceeds along

with its obligation to acquire replacement property under § 1033 to P3 for an X% general partner interest in P3 and a Y% limited partner interest in P3. AB will contribute \$J to P3 in exchange for a Z% limited partner interest in P3. P1 will then distribute its general and limited partner interests in P3 to CD.

The partnership agreements of P2 and P3 will require P2 and P3 to each reinvest approximately \$H of the condemnation proceeds, together with borrowed funds of approximately \$K, in replacement properties. If this is not done, the partnership agreements will require P1 to report the income from the lack of reinvestment under § 1033 on an amended income tax return for . The remaining land sale proceeds would be used for P1 operations. P1 has acquired two replacement properties in . The combined purchase price of the two properties is \$L.

Based on these facts, Taxpayer requests the following rulings:

- (1) The new limited partnerships P2 and P3 are partnerships under § 7701 and lack the corporate characteristics of continuity of life and limited liability.
- (2) The new partnerships P2 and P3 will each be a continuation of P1.
- (3) P1, P2 and P3 are each taxpayers under § 1033(a)(2)(A) and entitled to nonrecognition of gain under the § 1033 election made by P1 and can reinvest condemnation proceeds pursuant to the §1033 election of the original partnership, P1.
- (4) The partners of P1, AB and CD do not have to recognize any gain on the proposed distribution of the partnership interests in P2 and P3 under § 731.
- (5) The tax basis of replacement property acquired by P1, P2 and P3 will be its purchase price less its allocable share of the gain deferred under P1's § 1033 sale.
- (6) The capital accounts for P2 and P3 will be the cash contributed less the deferred gain as a result of the purchase of the replacement property under § 1033; and the basis and capital accounts of the partners in P1 will be increased by the basis reduction at the time of the P2 and P3 purchase of replacement property.

LAW AND ANALYSIS

(1) Entity status of P2 and P3

Section 301.7701-2(a) of the Procedure and Administration Regulations provides that a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code. Section 301.7701-3(a) provides that a business entity that is not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal tax purposes. Section 301.7701-3(b)(1)(i) provides that, unless the entity elects otherwise, a domestic eligible entity with two or more members is a partnership.

Based on the facts submitted, P2 and P3 are not trusts or otherwise subject to special treatment under the Code. Therefore, P2 and P3 are business entities within the meaning of § 301.7701-2(a). Furthermore, P2 and P3 are eligible entities under § 301.7701-3(a) because they are not classified as corporations under § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8). Therefore, unless P2 or P3 elect otherwise, P2 and P3 each will be a partnership for federal tax purposes.

(2) P2 and P3 as continuations of P1

Section 708(a) provides that an existing partnership will be considered as continuing if it is not terminated. Section 708(b)(1) provides that, for purposes of § 708(a), a partnership will be considered as terminated only if (A) no part of any business, financial operation or venture of the partnership continues to be carried on by any of its partners in a partnership, or (B) within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.

Section 708(b)(2)(B) provides that, in the case of a division of a partnership into two or more partnerships, the resulting partnerships (other than any resulting partnership the members of which had an interest of 50 percent or less in the capital and profits of the prior partnership) shall, for purposes of § 708, be considered a continuation of the prior partnership.

Section 1.708-1(d)(1) of the Income Tax Regulations provides that, upon the division of a partnership into two or more partnerships, any resulting partnership or resulting partnerships will be considered a continuation of the prior partnership if the members of the resulting partnership or partnerships had an interest of more than 50 percent in the capital and profits of the prior partnership.

Section 1.708-1(d)(4)(iv) provides that, for purposes of § 1.708-1(d), a resulting partnership is a partnership resulting from the division that exists under applicable jurisdictional law after the division and that has at least two partners who were partners in the prior partnership. For example, where a prior partnership divides into two partnerships, both partnerships existing after the division are resulting partnerships.

Section 1.708-1(d)(2)(ii) provides that all resulting partnerships that are regarded as continuing are subject to preexisting elections that were made by the prior partnership.

P1 is a continuing partnership under § 708 because, under the facts described, it will not be terminated. P2 and P3 will each be a continuation of P1 because the partners of P2 and P3 (AB and CD) had a greater than 50 percent interest in the capital and profits of P1. Therefore, P2 and P3 will be subject to preexisting elections that were made by P1, including an election under § 1033.

(3) Entitlement of P1, P2 and P3 to deferral of gain under election by P1 and reinvest condemnation proceeds

Section 1033(a)(2)(A) generally provides that if property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into money or into property not similar or related in service or use to the converted property, the gain (if any) shall be recognized except to the extent the taxpayer, during the period specified in § 1033(a)(2)(B), for the purpose of replacing the converted property, purchases other property similar or related in service or use to the property so converted. Under § 1033(a)(2)(A), gain is recognized only to the extent that the amount realized upon the conversion exceeds the cost of such other property.¹

Section 703(b) provides that an election affecting the computation of taxable income derived from a partnership must be made by the partnership. This rule applies to elections to be made under § 1033 when partnership property is condemned. Rev. Rul. 66-191, 1966-2 C.B. 300. In that circumstance, the election to defer gain must be made at the partnership level and replacement must be made by the partnership that held the condemned property. See *Dermirjian v. Commissioner*, 54 T.C.1691 (1970), *aff'd*, 457 F.2d 1 (3d Cir. 1972).

P1, P2 and P3 as continuing partnerships are subject to the pre-existing elections made by P1. Since P1, P2 and P3 are continuing partnerships of P1, each will be a taxpayer referred to in §1033(a)(2)(A) as the party that may defer gain under the election made by P1. Under such election, each continuing partnership is entitled to defer the gain it derives from the conversion by making timely reinvestments in property similar or related in service or use to the converted property, with respect to the share it receives of any condemnation proceeds.

¹ Under § 1033(a)(2)(B), a taxpayer generally has two years from the close of the first taxable year in which any gain from the conversion is realized to acquire property similar or related in service or use to the converted property. A three year replacement period is permitted for conversions described in § 1033(g) (a seizure, requisition, condemnation, or threat thereof, of real property). Valid replacements under §1033(g) must be of converted property held for productive use in a trade or business or for investment with like-kind property held for productive use in a trade or business or for investment.

(4) Treatment of P1's distribution of partnership interests in P2 and P3

Section 731(a)(1) provides that, in the case of a distribution by a partnership to a partner, gain will not be recognized to the partner, except to the extent that any money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution.

Section 1.708-1(d)(3)(i) provides that, when a partnership divides into two or more partnerships under applicable jurisdictional law without undertaking a form for the division, or undertakes a form that is not described in § 1.708-1(d)(3)(ii), the transaction will be characterized under the assets-over form for federal income tax purposes. Section 1.708-1(d)(3)(i)(A) provides that, in a division under the assets-over form where at least one resulting partnership is a continuation of the prior partnership, the divided partnership contributes certain assets and liabilities to a recipient partnership or recipient partnerships in exchange for interests in the recipient partnership or partnerships and, immediately thereafter, the divided partnership distributes the interests in the recipient partnership or partnerships to some or all of its partners in partial or complete liquidation of the partners' interests in the divided partnership.

Section 1.708-1(d)(4)(i) provides that, for purposes of § 1.708-1(d), the divided partnership is the continuing partnership that is treated, for federal income tax purposes, as transferring the assets and liabilities to the recipient partnership or partnerships, either directly (under the assets-over form) or indirectly (under the assets-up form). If the resulting partnership that, in form, transferred the assets and liabilities in connection with the division is a continuation of the prior partnership, then such resulting partnership will be treated as the divided partnership.

Section 1.708-1(d)(4)(ii) provides that, for purposes of § 1.708-1(d), the prior partnership is the partnership subject to division that exists under applicable jurisdictional law before the division.

Section 1.708-1(d)(4)(iii) provides that, for purposes of § 1.708-1(d), a recipient partnership is a partnership that is treated as receiving, for federal income tax purposes, assets and liabilities from a divided partnership, either directly (under the assets-over form) or indirectly (under the assets-up form).

The transfers from P1 to P2 and P3 and subsequent distributions of interests in P2 and P3 to AB and CD, respectively, will be treated as an assets-over division under § 1.708-1(d)(3)(i). Under § 731, no gain will be recognized by AB or CD on the distribution by P1 of interests in P2 and P3.

(5) Tax basis of replacement property

Section 1033(b) provides that in the case of property purchased by the taxpayer in a transaction described in § 1033 (a)(2) that resulted in the nonrecognition of any part of the gain realized as the result of a compulsory or involuntary conversion, the basis shall be the cost of such property decreased in the amount of the gain not so recognized. It also provides that if the property purchased consists of more than one piece of property, the basis must be allocated to the purchased properties in proportion to their respective costs.

Under the facts presented, each of the continuing partnerships will reinvest some or all of its share of the condemnation proceeds in one or more properties similar or related in service or use to the converted property.² In each case, as provided in § 1033(b), the basis of each replacement property acquired by the continuing partnership will be its cost decreased by the amount of gain not so recognized, as allocated to the purchased properties in proportion to the cost of each.

(6) Basis and Tax Capital accounts for P1, P2 and P3

Section 705(a) provides that the adjusted basis of a partner's interest in a partnership is, except as provided in § 705(b), the basis of the interest determined under § 722 or § 742 -- (1) increased by the sum of his distributive share for the taxable year and prior taxable years of -- (A) taxable income of the partnership as determined under § 703(a), (B) income of the partnership exempt from tax, and (C) the excess of the deductions for depletion over the basis of the property subject to depletion; (2) decreased (but not below zero) by distributions by the partnership as provided in § 733 and by the sum of his distributive share for the taxable year and prior taxable years of -- (A) losses of the partnership, and (B) expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account, and (3) decreased (but not below zero) by the amount of the partner's deduction for depletion for any partnership oil and gas property to the extent the deduction does not exceed the proportionate share of the adjusted basis of the property allocated to such partner under § 613A(c)(7)(D).

Section 722 provides that the basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership will be the amount of the money and the adjusted basis of the property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under § 721(b) to the contributing partner at that time.

Section 732(a)(1) provides that the basis of property (other than money) distributed by a partnership to a partner other than in liquidation of the partner's interest will, except as provided in § 732(a)(2), be its adjusted basis to the partnership immediately before the

² The continuing partnerships may also reinvest conversion proceeds in like-kind property as permitted under §1033(g).

distribution. Section 732(a)(2) provides that the basis to the distributee partner of the property received from the partnership will not exceed the adjusted basis of the partner's interest in the partnership reduced by any money distributed in the same transaction.

Section 733 provides that, in the case of a distribution by a partnership to a partner other than in liquidation of a partner's interest, the adjusted basis to the partner of his interest in the partnership will be reduced (but not below zero) by (1) the amount of any money distributed to the partner, and (2) the amount of the basis to the partner of distributed property other than money, as determined under § 732.

Section 752(a) provides that any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

The basis reduction in the replacement properties purchased by P1, P2 and P3 will be allocated to those properties in proportion to their respective costs, in accordance with § 1033(b)(2). Under these facts, the total basis and tax capital accounts of AB and CD in P2 and P3 will be the cash contributed to P2 and P3, respectively, less the deferred gain as a result of P2's and P3's purchase of the replacement property under § 1033, respectively. Furthermore, the basis and tax capital accounts of the partners in P1 will be increased by the basis reduction caused by P2's and P3's purchase of replacement property.

CONCLUSIONS

- (1) Unless P2 or P3 elect otherwise, P2 and P3 each will be a partnership for federal tax purposes.
- (2) P2 and P3 will each be a continuation of P1 and will be subject to preexisting elections that were made by P1, including an election under § 1033.
- (3) P1, P2 and P3, as continuing partnerships of P1, are each taxpayers under § 1033(a)(2)(A) and entitled to nonrecognition of gain under the § 1033 election made by P1. Each may defer gain by making a timely reinvestment of condemnation proceeds.
- (4) No gain will be recognized by AB or CD under § 731 on the distribution by P1 of interests in P2 and P3.
- (5) The tax basis of replacement property acquired by P1, P2 and P3 will be its purchase price less its allocable share of the gain deferred under P1's § 1033 sale.

- (6) The basis and tax capital accounts for the partners in P2 and P3 will be the cash contributed to P2 and P3, respectively, less the deferred gain as a result of P2's and P3's purchase of the replacement property under § 1033; and the basis and tax capital accounts of the partners in P1 will be increased by the basis reduction caused by P2's and P3's purchase of replacement property.

CAVEATS:

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Michael J. Montemurro
Branch Chief, Branch 4
(Income Tax & Accounting)

Enclosure (1)

cc: