Rev. Rul. 84-111, 1984-2 CB 88, IRC Sec(s). 351

Headnote:
Rev. Rul. 84-111, 1984-2 CB 88 -- IRC Sec. 351 (Also Sections 358, 362, 708, 732, 733, 735, 741, 751, 752, 2.1223; 1.358-1, 1.708-1, 1.732-1, 1.733-1, 1.735-1, 1.741-1, 1.751-1, 1.752-1, 1.1223-1).

Reference(s): Code Sec. 351; Reg § 1.351-1

Transfers; controlled corporations; partnership interests for stock.

Factual situations illustrate the transfer of partnership assets and liabilities to a newly formed corporation in exchange for all of its stock. Rev. Rul. 70-239 revoked and superseded.

Full Text:

ISSUE

Does Rev. Rul. 70-239, 1970-1 C.B. 74, still represent the Service's position with respect to the three situations described therein?

FACTS

The three situations described in Rev. Rul. 70-239 involve partnerships X, Y, and Z, respectively. Each partnership used the accrual method of accounting and had assets and liabilities consisting of cash, equipment, and accounts payable. The liabilities of each partnership did not exceed the adjusted basis of its assets. The three situations are as follows:

Situation 1

X transferred all of its assets to newly-formed corporation R in exchange for all the outstanding stock of R and the assumption by R of X's liabilities. X then terminated by distributing all the stock of R to X's partners in proportion to their partnership interests.

Situation 2

Y distributed all of its assets and liabilities to its partners in proportion to their partnership interests in a transaction that constituted a termination of Y under section 708(b)(1)(A) of the Code. The partners then transferred all the assets received from Y to newly-formed corporation S in exchange for all the outstanding stock of S and the assumption by S of Y's liabilities that had been assumed by the partners.

Situation 3

The partners of Z transferred their partnership interests in Z to newly-formed corporation T in exchange for all the outstanding stock of
This exchange terminated Z and all of its assets and liabilities became assets and liabilities of T.

In each situation, the steps taken by X, Y, and Z, and the partners of X, Y, and Z, were parts of a plan to transfer the partnership operations to a corporation organized for valid business reasons in exchange for its stock and were not devices to avoid or evade recognition of gain. Rev. Rul. 70-239 holds that because the federal income tax consequences of the three situations are the same, each partnership is considered to have transferred its assets and liabilities to a corporation in exchange for its stock under section 351 of the Internal Revenue Code, followed by a distribution of the stock to the partners in liquidation of the partnership.

**LAW AND ANALYSIS**

Section 351(a) of the Code provides that no gain or loss will be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation.

Section 1.351-1(a)(1) of the Income Tax Regulations provides that, as used in section 351 of the Code, the phrase “one or more persons” includes individuals, trusts, estates, partnerships, associations, companies, or corporations. To be in control of the transferee corporation, such person or persons must own immediately after the transfer stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of such corporation.

Section 358(a) of the Code provides that in the case of an exchange to which section 351 applies, the basis of the property permitted to be received under such section without the recognition of gain or loss will be the same as that of the property exchanged, decreased by the amount of any money received by the taxpayer.

Section 358(d) of the Code provides that where, as part of the consideration to the taxpayer, another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition (in the amount of the liability) will, for purposes of section 358, be treated as money received by the taxpayer on the exchange.

Section 362(a) of the Code provides that a corporation’s basis in property acquired in a transaction to which section 351 applies will be the same as it would be in the hands of the transferor.

Under section 708(b)(1)(A) of the Code, a partnership is terminated if 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. Under section 708(b)(1)(B), a partnership terminates if 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 732(b) of the Code provides that the basis of property other than money distributed by a partnership in a liquidation of a partner’s interest shall be an amount equal to the adjusted basis of the partner’s interest in the partnership reduced by any money distributed. Section 732(c) of the Code provides rules for the allocation of a partner’s basis in a partnership interest among the assets received in a liquidating distribution.

Section 735(b) of the Code provides that a partner’s holding period for property received in a distribution from a partnership (other than with respect to certain inventory items defined in section 751(d)(2)) includes the partnership’s holding period, as determined under section 1223, with respect to such property.

Section 1223(1) of the Code provides that where property received in an exchange acquires the same basis, in whole or in part, as the property surrendered in the exchange, the holding period of the property received includes the holding period of the property surrendered to the extent such surrendered property was a capital asset or property described in section 1231. Under section 1223(2), the holding period of a taxpayer’s property, however acquired, includes the period during which the property was held by any other person if that property has the same basis, in whole or in part, in the taxpayer’s hands as it would have in the hands of such other person.

Section 741 of the Code provides that in the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as a gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751.

Section 751(a) of the Code provides that the amount of money or the fair value of property received by a transferor partner in exchange for all or part of such partner’s interest in the partnership attributable to unrealized receivables of the partnership, or to inventory items of the partnership that have appreciated substantially in value, shall be considered as an amount realized from the sale or exchange of property other than a capital asset.

Section 752(a) of the Code 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 the partner of partnership liabilities, will be considered as a contribution of money by such partner to the partnership.

Section 752(b) of the Code provides that any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, will be considered as a distribution of money to the partner by the partnership. Under section 733(1) of the Code, the basis of a partner's interest in the partnership is reduced by the amount of money received in a distribution that is not in liquidation of the partnership.

Section 752(d) of the Code provides that in the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships.

The premise in Rev. Rul. 70-239 that the federal income tax consequences of the three situations described therein would be the same, without regard to which of the three transactions was entered into, is incorrect. As described below, depending on the format chosen for the transfer to a controlled corporation, the basis and holding periods of the various assets received by the corporation and the basis and holding periods of the stock received by the former partners can vary.

Additionally, Rev. Rul. 70-239 raises questions about potential adverse tax consequences to taxpayers in certain cases involving collapsible corporations defined in section 341 of the Code, personal holding companies described in section 542, small business corporations defined in section 1244, and electing small business corporations defined in section 1371. Recognition of the three possible methods to incorporate a partnership will enable taxpayers to avoid the above potential pitfalls and will facilitate flexibility with respect to the basis and holding periods of the assets received in the exchange.

HOLDING

Rev. Rul. 70-239 no longer represents the Service's position. The Service's current position is set forth below, and for each situation, the methods described and the underlying assumptions and purposes must be satisfied for the conclusions of this revenue ruling to be applicable.

Situation 1

Under section 351 of the Code, gain or loss is not recognized by X on the transfer by X of all of its assets to R in exchange for R's stock and the assumption by R of X's liabilities.

Under section 362(a) of the Code, R's basis in the assets received from X equals their basis to X immediately before their transfer to R. Under section 358(a), the basis to X of the stock received from R is the same as the basis to X of the assets transferred to R, reduced by the liabilities assumed by R, which assumption is treated as a payment of money to X under section 358(d). In addition, the assumption by R of X's liabilities decreased each partner's share of the partnership liabilities, thus, decreasing the basis of each partner's partnership interest pursuant to sections 752 and 733.

On distribution of the stock to X's partners, X terminated under section 708(b)(1)(A) of the Code. Pursuant to section 732(b), the basis of the stock distributed to the partners in liquidation of their partnership interests is, with respect to each partner, equal to the adjusted basis of the partner's interest in the partnership.

Under section 1223(1) of the Code, X's holding period for the stock received in the exchange includes its holding period in the capital assets and section 1231 assets transferred (to the extent that the stock was received in exchange for such assets). To the extent the stock was received in exchange for neither capital nor section 1231 assets, X's holding period for such stock begins on the day following the date of the exchange. See Rev. Rul. 70-596, 1970-2 C.B. 168. Under section 1223(2), R's holding period in the assets transferred to it includes X's holding period. When X distributed the R stock to its partners, under sections 735(b) and 1223, the partners' holding periods included X's holding period of the stock. Furthermore, such distribution will not violate the control requirement of section 368(c) of the Code.

Situation 2

On the transfer of all of Y's assets to its partners, Y terminated under section 708(b)(1)(A) of the Code, and, pursuant to section 732(b), the basis of the assets (other than money) distributed to the partners in liquidation of their partnership interests in Y was, with respect to each partner, equal to the adjusted basis of the partner's interest in Y, reduced by the money distributed. Under section 752, the decrease in Y's liabilities resulting from the transfer to Y's partners was offset by the partners' corresponding assumption of such liabilities so that the net effect on the basis of each partner's interest in Y, with respect to the liabilities transferred, was zero.
Under section 351 of the Code, gain or loss is not recognized by Y's former partners on the transfer to S in exchange for its stock and the assumption of Y's liabilities, of the assets of Y received by Y's partners in liquidation of Y.

Under section 358(a) of the Code, the basis to the former partners of Y in the stock received from S is the same as the section 732(b) basis to the former partners of Y in the assets received in liquidation of Y and transferred to S, reduced by the liabilities assumed by S, which assumption is treated as a payment of money to the partners under section 358(d).

Under section 362(a) of the Code, S's basis in the assets received from Y's former partners equals their basis in the former partners as determined under section 732(c) immediately before the transfer to S.

Under section 735(b) of the Code, the partners' holding periods for the assets distributed to them by Y includes Y's holding period. Under section 1223(1), the partners' holding periods for the stock received in the exchange includes the partners' holding periods in the capital assets and section 1231 assets transferred to S (to the extent that the stock was received in exchange for such assets). However, to the extent that the stock received was in exchange for neither capital nor section 1231 assets, the holding period of the stock began on the day following the date of the exchange. Under section 1223(2), S's holding period of the Y assets received in the exchange includes the partner's holding periods.

**Situation 3**

Under section 351 of the Code, gain or loss is not recognized by Z's partners on the transfer of the partnership interests to T in exchange for T's stock.

On the transfer of the partnership interests to the corporation, Z terminated under section 708(b)(1)(A) of the Code.

Under section 358(a) of the Code, the basis to the partners of Z of the stock received from T in exchange for their partnership interests equals the basis of their partnership interests transferred to T, reduced by Z's liabilities assumed by T, the release from which is treated as a payment of money to Z's partners under sections 752(d) and 358(d).

T's basis for the assets received in the exchange equals the basis of the partners in their partnership interests allocated in accordance with section 732(c). T's holding period includes Z's holding period in the assets.

Under section 1223(1) of the Code, the holding period of the T stock received by the former partners of Z includes each respective partner's holding period for the partnership interest transferred, except that the holding period of the T stock that was received by the partners of Z in exchange for their interests in section 751 assets of Z that are neither capital assets nor section 1231 assets begins on the day following the date of the exchange.

**EFFECT ON OTHER DOCUMENTS**

Pursuant to the authority contained in section 7805(b) of the Code, this revenue ruling will not apply adversely to taxpayers who, before July 23, 1984, the date of publication of this revenue ruling in the Internal Revenue Bulletin, entered into one of the three transactions described in Rev. Rul. 70-239 in reliance on the Service's position as published therein.

This revenue ruling supersedes and revokes Rev. Rul. 70-239.