INCORPORATING A PARTNERSHIP – A REFRESHER COURSE

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I. <u>Why Incorporate</u>?

A. <u>VC Investment</u>. A typical VC fund is formed as a partnership or an LLC taxable as a partnership. Most have either charitable foundations or retirement funds as investors – and those kinds of investors typically insist on avoiding unrelated business taxable income. A flow-through portfolio company would generate UBTI to a VC fund and its investors, while an unleveraged investment in a C corporation would not do so.

B. <u>Potential Future Reorg</u>. Many start-up organizations plan an exit strategy in which they will be acquired by a public (or pre-IPO) corporation. This can often be achieved in a tax-deferred reorganization if the start-up organization is a corporation, but not if the start-up organization is taxable as a partnership. Note that incorporation immediately prior to a follow-up corporate acquisition may ***not*** meet the tests of Section 351 for nonrecognition treatment, since the owners of the incorporating entity would not be respected as having control of the new corporation "immediately after" the incorporation occurs. ***See*** Revenue Ruling 54-96, 1954-1 C.B. 111.

C. <u>Stock Options</u>. An organization taxable as a partnership cannot grant ISOs. It could grant either profits interests or a version of a nonqualified option, but neither of those forms of equity compensation is as familiar as an ISO or a conventional nonstatutory stock option.

D. <u>Professional Activities</u>. There are a limited number of professional, licensed activities that can be carried on through a limited liability entity only if the entity is a professional corporation – examples are real estate brokerage and medical practice.

E. <u>Those Danged K-1's</u>. A lot of workers are just more comfortable receiving Forms W-2 and 1099 – Forms K-1 tend to be a bit intimidating to persons without a tax or accounting background. Also, see Revenue Ruling 69-184, 1969-1 C. B. 256 ("bona fide" members of a partnership are ***not*** employees for purposes of wage withholding, FICA or FUTA – their compensation income is reported on a K-1 as a guaranteed payment or a distributive share).

II. <u>The Six Methods of Getting the Job Done</u>.

There are multiple ways of handling the mechanics of converting a partnership or LLC into a corporation.

A. <u>File a Check-the-Box Election</u>. A simple way of changing an entity's tax status is to file a "check-the-box" election on Form 8832. The Form can be retroactive up to 75 days prior to the filing date. This election will only change the entity's ***tax*** status; an LLC will remain an LLC for non-tax purposes even if it has elected under Form 8832 to be taxed as a corporation. Note that Form 8832 can be signed either by all members or by an authorized manager of the LLC.

B. <u>Conversion</u>. A California partnership or LLC can be incorporated by filing Articles of Incorporation containing a "statement of conversion" with the California Secretary of State. No new entity need be formed, and no old entity need be dissolved. Most other states have comparable conversion statutes.

C. <u>Cross-Species Merger into Corporate Newco</u>. An existing partnership or LLC can merge a new shell corporation. All liabilities and assets of the existing partnership or LLC will then transfer to the corporate Newco.

D. <u>Transfer of Assets to Corporate Newco and Distribution of Newco Shares to Individual Owners</u>. The existing LLC or partnership can transfer all of its assets to a wholly-owned corporate Newco and then distribute the stock of Newco to the LLC's or partnership's owners. The existing LLC or partnership would then dissolve.

E. <u>Distribution of Assets to Owners and Owners' Contribution to Corporate Newco</u>. The existing LLC or partnership can distribute all of its assets to its owners, and the owners can then contribute the assets to a corporate Newco. This may require the unanimous cooperation of all owners of the existing LLC or partnership. This approach also requires that the owners accept at least momentary loss of limited liability protection with respect to the assets owned and the business being conducted.

F. <u>Contribution of Ownership Interests to Corporate Newco</u>. All of the existing members or partners could contribute their ownership interests to a corporate Newco in exchange for Newco's shares. If the existing entity had been a partnership, the consolidation of ownership in a single corporate Newco would trigger the deemed dissolution of the partnership. If the existing entity had been an LLC, the consolidation of ownership would not automatically terminate the existence of the LLC, which would continue as a wholly-owned sub of corporate Newco (though the LLC would likely become a "disregarded entity" for most tax purposes). This form of incorporation typically requires the unanimous action of all owners.

III. <u>The Three Tax Analyses – Revenue Ruling 84-111</u>.

A. <u>Historical Development – Revenue Ruling 70-239 Revoked</u>. Initially, in Revenue Ruling 70-239, 1970-1 C.B. 74, the IRS had indicated that any incorporation of a partnership would be analyzed as though it involved a partnership contributing all of its assets to a corporate Newco, after which the partnership distributes the Newco shares to its partners and then liquidates. In Revenue Ruling 84-111, 1984-2 C.B. 88, however, the IRS reconsidered that position and announced that there are three possible techniques of incorporating a partnership, each of which would be analyzed for tax purposes according to the steps the taxpayers actually take. For purposes of this analysis, the incorporation methodologies described above in sections II.A through II.C are all treated as though they followed the steps described in section II.D – that is, as though the existing entity contributes it assets to a corporate Newco and then distributes the corporate Newco shares to the existing entity's owners. ***See*** Revenue Ruling 2004-59, 2004-1 C.B. 1050 (incorporation via "formless" conversion statute) and Treas. Reg. Section 301.7701-3(g)(1)(i) (incorporation via check-the-box election). A copy of Revenue Ruling 84-111 is attached to this outline as Exhibit A.

B. <u>The Three Tax Analyses</u>. The three separate tax analyses track the incorporation techniques described in section II.D, II.E and II.F above. Each analysis has gathered its own set of tax-jargon nicknames – there is not yet perfect uniformity about the nomenclature:

1. <u>Assets Over – Partnership Asset Transfer – Alternative 1 Transaction</u>. These phrases all describe the partnership's transfer of assets to Newco followed by the partnership's distribution of Newco shares and the partnership's liquidation.

2. <u>Assets Up – Partner Asset Transfer – Alternative 2 Transaction</u>. In these transactions, the partnership liquidates, distributing all of its assets to the partners. The partners then contribute the assets to a corporate Newco in exchange for Newco shares.

3. <u>Interests Up -- Partnership Interest Transfer – Alternative 3 Transaction</u>. These phrases describe a transaction in which all partners transfer their partnership interests to a corporate Newco in exchange for Newco shares.

C. <u>Significant Similarities Among the Three Tax Analyses</u>. The similarities among the three tax analyses, in most instances, far outweigh the differences. In each:

1. <u>Section 351 Treatment</u>. Section 351 will allow for general nonrecognition of gain.

2. <u>Debt in Excess of Basis</u>. Partnership debt assumed in excess of asset basis will be an exception to Section 351 treatment, triggering the recognition of gain to the extent of the excess debt. ***See*** Section 357(c) of the Internal Code of 1986, as amended (the "Code").

3. <u>Corporate Newco's Holding Period in Its Assets</u>. Newco's holding period in the assets received will generally tack to the holding period of the partnership in the assets.

4. <u>Basis of the Partners in the Newco Shares Received</u>. Each partner will normally claim a basis in his shares of Newco equal to the basis in his partnership interest, reduced by liabilities assumed and increased by gain recognized.

D. <u>Subtle Differences Among the Three Tax Analyses</u>. While the overall tax consequences tend to be similar for all three analyses, there can be subtle tax differences.

1. <u>Corporate Newco's Basis in Its Assets</u>. Under Alt 1, Newco's basis will equal ***the partnership's bases in the assets*** increased by the amount of any gain the partnership recognizes on the transfer. Under Alt 2, Newco's basis will equal ***the partners' bases in the assets*** increased by the amount of any gain recognized by the partners on the transfer. Under Alt 3, Newco's basis will equal ***the partners' bases in their partnership interests*** increased by the amount of any gain recognized by the partners on the transfer. In all cases, Newco's asset basis may not exceed the assets' FMV on the date of transfer. ***See*** Section 362(e) of the Code. Note that these rules make it important to consider basis outcomes for partnerships in which there is a meaningful difference between inside and outside basis – that is, for partnerships that have not made a Section 754 election to adjust basis on the transfer of partnership interests.

2. <u>Holding Period of Partners in Their Newco Shares</u>. In Alt 1 and Alt 2, a partner's holding period in his Newco shares is generally tacked to ***the partnership's holding period in***

its capital assets and Section 1231 assets – to the extent the Newco shares are attributable to all other assets of the partnership, the holding period will commence the day following the incorporation. In Alt 3, a partner's holding period in his Newco shares is generally tacked to ***the partner's holding period in his partnership interest***, except that holding period attributable to the partner's indirect interest in Section 751 assets of the partnership will commence the day following the incorporation. ***See*** Revenue Ruling 84-111, 1984-2 C.B. 88.

3. Temporary Ownership of Stock by a Partnership. There are at least three areas in which the ownership of a corporation's stock by a partnership can create tax issues. These issues can therefore arise under Alt 1 but not under Alt 2 or Alt 3, since Alt 1 creates at least momentary ownership of all of Newco's shares by a partnership. If momentary ownership can be overlooked, these Alt 1 issues melt away – and there is strong support for overlooking momentary ownership in this and other contexts. ***See, e.g.***, PLR 9421022 (partnership's momentary ownership of S corporation stock is disregarded); Revenue Ruling 72-320, 1972-1 C.B. 270 (parent corporation's temporary ownership of spun-off subsidiary is disregarded).

a. Personal Holding Company Status. Ownership by a single partnership can cause sufficient consolidation of ownership, under relevant attribution rules, to cause a corporation to meet the fifty-percent ownership test for PHC status. That test requires that more than 50 percent of a corporation's be owned, directly or indirectly, by five or fewer family groups at any time during the second half of the taxable year – note that momentary ownership at the very commencement of a corporation's first taxable year is unlikely to trigger PHC status under this test. ***See also*** Section 544(a)(2) of the Code (attribution among partners).

b. Section 1244 Stock. Section 1244 ordinary loss treatment is not available to a partner who receives otherwise eligible 1244 stock as a distribution from a partnership. ***See*** Treas. Reg. Section 1.1244(a)-1(b)(2).

c. S Eligibility. An S corporation cannot have a partnership as a shareholder. ***But see*** PLRs 9421022, 9010042, 8948015, 8934020, 8926016, 8922004 (permitting transitory partnership ownership in connection with an incorporation) and Revenue Ruling 2009-15, 2009-21 I.R.B. 1035 (partnership that incorporates by checking the box or undergoing a formless conversion is eligible for S status from the date of its incorporation, notwithstanding Alt 1 analysis of the incorporating events).

IV. Traps and Solutions

A. Nonqualified Preferred Stock Treated as Boot. Remember that nonqualified preferred stock is treated as boot in a Section 351 transaction. NQPS is generally preferred stock that is puttable or callable, or that has a dividend rate tied to interest rates or commodity prices. If corporate Newco issues preferred stock on formation, review Section 351(g) of the Code to ensure that there are no issues with NQPS. (Tip – ***participating*** preferred will generally not be treated as "preferred stock" for NQPS purposes.)

B. Debt in Excess of Asset Basis. An important checklist item for all partnership incorporations will involve Newco's assumption of debt in excess of the bases in the assets contributed to Newco. Under Section 357(c) of the Code, such an assumption can trigger gain notwithstanding the application of Section 351. If there is a potential debt-in-excess-of-basis issue, consider (i) having individual partners assume a portion of the debt associated with the business, so that the corporation is not treated as the principal obligor, (ii) having the partners contribute additional unencumbered property to Newco in connection with the incorporation so that there ceases to be an excess of debt over basis or (iii) reminding the partners that the excess of debt over basis likely means that they have claimed tax benefits in excess of their cash investment in the partnership, and that the application of Section 357(c) to the incorporation merely represents a "recapture" of those leveraged tax benefits.

C. Outstanding Compensatory Equity. If the converting partnership has outstanding compensatory equity, any conversion strategy must address the rights of the holders of those equity interests.

1. Options. Some partnerships award "unit" options to their workers. These options allow an optionee to purchase an equity stake in the partnership at a fixed exercise price. A client's normal expectation is that such option obligations will merely be assumed by a successor corporation. There is, however, nothing in the Code that would permit a partnership optionee to "swap" a partnership unit option for a corporate stock option without triggering the recognition of gain. A partnership and it optionees could agree to cancel the unit options and replace them with comparable stock options – but if the stock options are in-the-money as of the date of issuance, they could not be ISOs and they would have to have to comply with the rigid timing requirements of Section 409A of the Code. A successor corporation could address this by issuing new at-the-money stock options and agreeing to provide some other benefit to compensate the optionee for an increased exercise price.

2. Unvested Equity. If a partner owns partnership units that are subject to a substantial risk of forfeiture, in most instances the partner will have filed a Section 83(b) election upon receipt. If that partner swaps his unvested units for similarly restricted stock in the corporate Newco, it is normally advisable for the partner to file a new Section 83(b) election within 30 days of the effective date of the incorporation. If a partner owns restricted shares and had not filed a Section 83(b) election upon receipt, there is some doubt that the partner could be treated as part of the control group in determining whether the incorporation qualifies under Section 351 of the Code.

3. Profits Interests. A recurring problem in partnership incorporations involves the treatment of outstanding profits interests. A profits interest cannot allow the recipient to obtain an immediate interest in the capital value of the issuing partnership. That means that holders of regular partnership interests will typically have a larger proportionate claim on the overall equity of the organization than holders of profits interests. Holders of regular partnership interests should therefore either receive some form of preferred stock to reflect their larger claim on the organization's capital value or receive a disproportionately large share of the common stock. ***See also*** Revenue Procedure 93-27, 1993-2 C.B. 343 (safe harbor for profits interest tax treatment is not available if recipient disposes of the profits interest within two years of grant).

D. **Assignment of Income.** If a partnership transfers substantially all of the assets of an ongoing business to a newly-formed corporation, the IRS will generally ***not*** apply the assignment-of-income doctrine to assert recognition of income with respect to transferred accounts receivable. ***See*** Revenue Ruling 80-198, 1980-2 C.B. 113

E. **Qualified Small Business Stock.** Certain domestic C corporations are eligible to issue qualified small business stock, or QSBS, that will allow individual shareholders to qualify for a reduced rate of tax on sale of the stock at a gain. Generally, QSBS must be issued directly to an individual for a contribution of either services or property. On the incorporation of an existing partnership, the Code provides that stock ultimately issued to individual owners can be QSBS, but the that portion of gain eligible for QSBS treatment is limited to the appreciation that occurs following the date of incorporation – any appreciation attributable to the period of partnership operation will remain subject to normal capital gain tax rates. ***See*** Section 1202(i)(1)(B) of the Code. Upon incorporation, therefore, it may be important to document the fair market value of the organization as of the effective date, either through an appraisal or, more informally, through a recital in the incorporating documents.

F. **Stub Year.** Remember that the partnership will have to file a stub year return for the period of the year preceding the effective date of the incorporation, and that the resulting corporation will have to file a stub year return for the period of the year following the effective date of the incorporation. If the partnership had been formed as a limited partnership or LLC operating in California, the additional stub year may trigger an additional $800 minimum franchise tax for the year of incorporation. Consider timing the incorporation to coincide with the end of a month or quarterly accounting period.

G. **Follow-Up Reorg.** As mentioned above, a corporate reorganization that quickly follows the incorporation may prevent the initial incorporating transaction from qualifying under Section 351 of the Code. ***See*** Revenue Ruling 54-96, 1954-1 C.B. 111. This issue would become less threatening if the partners continue to own at least 80 percent of any corporation that results from the follow-up reorganization.

EXHIBIT A

REV. RUL. 84-111, 1984-2 C.B. 88

Three Tax Analyses for the Incorporation of a Partnership

REV. RUL. 84-111, 1984-2 C.B. 88

ISSUE

Does Rev. Rul. 70-239, 1970 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 T. 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. 70-598, 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 to 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.