

(iii) *Assumptions.* An S corporation that does not use written data pursuant to paragraph (g)(5)(ii) of this section to determine a shareholder's section 1254 costs must use the following assumptions to determine the shareholder's section 1254 costs—

(A) The shareholder deducted his or her share of the amount of deductions under sections 263(c), 616, and 617 in the first year in which the shareholder could claim a deduction for such amounts, unless in the case of expenditures under sections 263(c) or 616 the S corporation elected to capitalize such amounts;

(B) The shareholder was not subject to the following limitations with respect to the shareholder's depletion allowance under section 611, except to the extent a limitation applied at the corporate level: the taxable income limitation of section 613(a); the depletable quantity limitations of section 613A(c); or the limitations of sections 613A(d)(2), (3), and (4) (exclusion of retailers and refiners).

(6) *Examples.* The following examples illustrate the provisions of this paragraph (g):

*Example 1. Transfer of natural resource recapture property to an S corporation in a section 351 transaction.* As of January 1, 1997, A owns all the stock (20 shares) in X, an S corporation. X holds property that is not natural resource recapture property that has a fair market value of \$2,000 and an adjusted basis of \$2,000. On January 1, 1997, B transfers natural resource recapture property, Property P, to X in exchange for 80 shares of X stock in a transaction that qualifies under section 351. Property P has a fair market value of \$8,000 and an adjusted basis of \$5,000. Pursuant to section 351, B does not recognize gain on the transaction. Immediately prior to the transaction, B's section 1254 costs with respect to Property P equaled \$6,000. Under § 1.1254-2(c)(1), B does not recognize any gain under section 1254 on the section 351 transaction and, under § 1.1254-3(b)(1), X's section 1254 costs with respect to Property P immediately after the contribution equal \$6,000. Under paragraph (g)(2) of this section, each shareholder is allocated a pro rata share of X's section 1254 costs. The pro rata share of X's section 1254 costs that is allocated to A equals \$1,200 (20 percent interest in X multiplied by X's \$6,000 of section 1254 costs). The pro rata share of X's section 1254 costs that is allocated to B equals \$4,800 (80 percent interest in X multiplied by X's \$6,000 of section 1254 costs).

*Example 2. Contribution of money in exchange for stock of an S corporation holding natural resource recapture property.* As of January 1, 1997, A and B each own 50 percent of the stock (50 shares each) in X, an S corporation. X holds natural resource recapture property, Property P, which has a fair market value of \$20,000 and an adjusted basis of \$14,000. A's and B's section 1254 costs with respect to Property P are \$4,000 and \$1,500, respectively. On January 1, 1997, C contributes \$20,000 to X in exchange for 100 shares of X's stock. Under paragraph (g)(1)(i) of this section, X must allocate to C a pro rata share of its shareholders' section 1254 costs. Using the assumptions set forth in paragraph (g)(5)(iii) of this section, X determines that A's section 1254 costs with respect to natural resource recapture property held by X equal \$4,500. Using written data provided by B, X determines that B's section 1254 costs with respect to Property P equal \$1,500. Thus, the aggregate of X's shareholders' section 1254 costs equals \$6,000. C's pro rata share of the \$6,000 of section 1254 costs equals \$3,000 (C's 50 percent interest in X multiplied by \$6,000). Under paragraph (g)(1)(ii) of this section, A's section 1254 costs are reduced by \$2,000 (A's actual section 1254 costs (\$4,000) multiplied by 50 percent). B's section 1254 costs are reduced by \$750 (B's actual section 1254 costs (\$1,500) multiplied by 50 percent).

*Example 3. Merger involving an S corporation that holds natural resource recapture property.* X, an S corporation with one shareholder, A, holds as its sole asset natural resource recapture property that has a fair market value of \$120,000 and an adjusted basis of \$40,000. A has section 1254 costs with respect to the property of \$60,000. For valid business reasons, X merges into Y, an S corporation with one shareholder, B, in a reorganization described in section 368(a)(1)(A). Y holds property that is not natural resource recapture property that has a fair market value of \$120,000 and basis of \$120,000. Under paragraph (c) of this section, A does not recognize ordinary income under section 1254 upon the exchange of stock in the merger because A did not otherwise recognize gain on the merger. Under paragraph (g)(2) of this section, Y must allocate to A and B a pro rata share of its \$60,000 of section 1254 costs. Thus, A and B are each allocated \$30,000 of section 1254 costs (50 percent interest in X, each, multiplied by \$60,000).

[T.D. 8684, 61 FR 53063, Oct. 10, 1996]

#### § 1.1254-5 Special rules for partnerships and their partners.

(a) *In general.* This section provides rules for applying the provisions of section 1254 to partnerships and their partners upon the disposition of natural resource recapture property by the

partnership and certain distributions of property by a partnership. See section 751 and the regulations thereunder for rules concerning the treatment of gain upon the transfer of a partnership interest.

(b) *Determination of gain treated as ordinary income under section 1254 upon the disposition of natural resource recapture property by a partnership*—(1) *General rule.* Upon a disposition of natural resource recapture property by a partnership, the amount treated as ordinary income under section 1254 is determined at the partner level. Each partner must recognize as ordinary income under section 1254 the lesser of—

(i) The partner's section 1254 costs with respect to the property disposed of; or

(ii) The partner's share of the amount, if any, by which the amount realized upon the sale, exchange, or involuntary conversion, or the fair market value of the property upon any other disposition, exceeds the adjusted basis of the property.

(2) *Exception to partner level recapture in the case of abusive allocations.* Paragraph (b)(1) of this section does not apply in determining the amount treated as ordinary income under section 1254 upon a disposition of section 1254 property by a partnership if the partnership has allocated the amount realized or gain recognized from the disposition with a principal purpose of avoiding the recognition of ordinary income under section 1254. In such case, the amount of gain on the disposition recaptured as ordinary income under section 1254 is determined at the partnership level.

(3) *Examples.* The provisions of paragraphs (a) and (b) of this section are illustrated by the following examples which assume that capital accounts are maintained in accordance with section 704(b) and the regulations thereunder:

*Example 1. Partner level recapture*—In general, A, B, and C, have equal interests in capital in Partnership ABC that was formed on January 1, 1985. The partnership acquired an undeveloped domestic oil property on January 1, 1985, for \$120,000. The partnership allocated the property's basis to each partner in proportion to the partner's interest in partnership capital, so each partner was allocated \$40,000 of basis. In 1985, the partnership incurred \$60,000 of productive well intangible

drilling and development costs with respect to the property. The partnership elected to deduct the intangible drilling and development costs as expenses under section 263(c). Each partner deducted \$20,000 of the intangible drilling and development costs. Assume that depletion allowable under section 613A(c)(7)(D) for each partner for 1985 was \$10,000. On January 1, 1986, the partnership sold the oil property to an unrelated third party for \$210,000. Each partner's allocable share of the amount realized is \$70,000. Each partner's basis in the oil property at the end of 1985 is \$30,000 (\$40,000 cost—\$10,000 depletion deductions claimed). Each partner has a gain of \$40,000 on the sale of the oil property (\$70,000 amount realized—\$30,000 adjusted basis in the oil property). Assume that each partner's depletion allowance would not have been increased if the intangible drilling and development costs had been capitalized. Each partner's section 1254 costs with respect to the property are \$20,000. Thus, A, B, and C each must treat \$20,000 of gain recognized as ordinary income under section 1254(a).

*Example 2. Special allocation of intangible drilling and development costs.* K and L form a partnership on January 1, 1997, to acquire and develop a geothermal property as defined under section 613(e)(2). The partnership agreement provides that all intangible drilling and development costs will be allocated to partner K, and that all other items of income, gain, or loss will be allocated equally between the two partners. Assume these allocations have substantial economic effect under section 704(b) and the regulations thereunder. The partnership acquires a lease covering undeveloped acreage located in the United States for \$50,000. In 1997, the partnership incurs \$50,000 of intangible drilling and development costs that are allocated to partner K. The partnership also has \$30,000 of depletion deductions, which are allocated equally between K and L. On January 1, 1998, the partnership sells the geothermal property to an unrelated third party for \$160,000 and recognizes a gain of \$140,000 (\$160,000 amount realized less \$20,000 adjusted basis (\$50,000 unadjusted basis less \$30,000 depletion deductions)). This gain is allocated equally between K and L. Because K's section 1254 costs are \$65,000 and L's section 1254 costs are \$15,000, K recognizes \$65,000 as ordinary income under section 1254(a) and L recognizes \$15,000 as ordinary income under section 1254(a). The remaining \$5,000 of gain allocated to K and \$55,000 of gain allocated to L is characterized without regard to section 1254.

*Example 3. Section 59(e) election to capitalize intangible drilling and development costs.* Partnership DK has 50 equal partners. On January 1, 1995, the partnership purchases an undeveloped oil and gas property for \$100,000. The partnership allocates the property's

basis equally among the partners, so each partner is allocated \$2,000 of basis. In January 1995, the partnership incurs \$240,000 of intangible drilling and development costs with respect to the property. The partnership elects to deduct the intangible drilling and development costs as expenses under section 263(c). Each partner is allocated \$4,800 of intangible drilling and development costs. One of the partners, H, elects under section 59(e) to capitalize his \$4,800 share of intangible drilling and development costs. Therefore, H is permitted to amortize his \$4,800 share of intangible drilling and development costs over 60 months. H takes a \$960 amortization deduction in 1995. Each of the remaining 49 partners deducts his \$4,800 share of intangible drilling and development costs in 1995. Assume that depletion allowable for each partner under section 613A(c)(7)(D) for 1995 is \$1,000. On December 31, 1995, the partnership sells the property for \$300,000. Each partner is allocated \$6,000 of amount realized. Each partner that deducted the intangible drilling and development costs has a basis in the oil property at the end of 1995 of \$1,000 (\$2,000 cost - \$1,000 depletion deductions claimed). Each of these partners has a gain of \$5,000 on the sale of the oil property (\$6,000 amount realized - \$1,000 adjusted basis in the property). The section 1254 costs of each partner that deducted intangible drilling and development costs are \$5,800 (\$4,800 intangible drilling and development costs deducted + \$1,000 depletion deductions claimed). Because each partner's section 1254 costs (\$5,800) exceed each partner's share of amount realized less each partner's adjusted basis (\$5,000), each partner must treat his \$5,000 gain recognized on the sale of the oil property as ordinary income under section 1254(a). Because H elected under section 59(e) to capitalize the \$4,800 of intangible drilling and development costs and amortized only \$960 of the costs in 1995, the \$3,840 of unamortized intangible drilling and development costs are included in H's basis in the oil property. Therefore, at the end of 1995 H's basis in the oil property is \$4,840 ((\$2,000 cost + \$4,800 capitalized intangible drilling and development costs) - (\$960 intangible drilling and development costs amortized + \$1,000 depletion deduction claimed)). H's gain on the sale of the oil property is \$1,160 (\$6,000 amount realized - \$4,840 adjusted basis). H's section 1254 costs are \$1,960 (\$960 intangible drilling and development costs amortized + \$1,000 depletion deductions claimed). Because H's section 1254 costs (\$1,960) exceed H's share of amount realized less H's adjusted basis (\$1,160), H must treat the \$1,160 of gain recognized as ordinary income under section 1254(a).

(c) *Section 1254 costs of a partner*—(1) *General rule.* A partner's section 1254 costs with respect to property held by a partnership include all of the part-

ner's section 1254 costs with respect to the property in the hands of the partnership. In the case of property contributed to a partnership in a transaction described in section 721, a partner's section 1254 costs include all of the partner's section 1254 costs with respect to the property prior to contribution. Section 1.1254-1(b)(1)(iv), which provides rules concerning the treatment of suspended deductions, applies to amounts not deductible pursuant to section 704(d).

(2) *Section 1254 costs of a transferee partner after certain acquisitions*—(i) *Basis determined under section 1012.* If a person acquires an interest in a partnership that holds natural resource recapture property (transferee partner) and the transferee partner's basis for the interest is determined by reference to its cost (within the meaning of section 1012), the amount of the transferee partner's section 1254 costs with respect to the property held by the partnership is zero on the acquisition date.

(ii) *Basis determined by reason of the application of section 1014(a).* If a transferee partner acquires an interest in a partnership that holds natural resource recapture property from a decedent and the transferee partner's basis is determined, by reason of the application of section 1014(a), solely by reference to the fair market value of the partnership interest on the date of the decedent's death or on the applicable date provided in section 2032 (relating to alternate valuation date), the amount of the transferee partner's section 1254 costs with respect to property held by the partnership is zero on the acquisition date.

(iii) *Basis determined by reason of the application of section 1014(b)(9).* If an interest in a partnership that holds natural resource recapture property is acquired before the death of the decedent, the amount of the transferee partner's section 1254 costs with respect to property held by the partnership shall include the amount, if any, of the section 1254 costs deducted by the transferee partner before the decedent's death, to the extent that the basis of the partner's interest (determined under section 1014(a)) is required to be reduced under section 1014(b)(9) (relating to adjustments to basis when the property is

acquired before the death of the decedent).

(iv) *Gifts and section 1041 transfers.* If an interest in a partnership is transferred in a transfer that is a gift, a part sale or exchange and part gift, or a transfer that is described in section 1041(a), the amount of the transferee partner's section 1254 costs with respect to property held by the partnership immediately after the transfer is an amount equal to—

(A) The amount of the transferor partner's section 1254 costs with respect to the property immediately before the transfer; minus

(B) The amount of any gain recognized as ordinary income under section 1254 by the transferor partner upon the transfer.

(d) *Property distributed to a partner—*  
(1) *In general.* The section 1254 costs for any natural resource recapture property received by a partner in a distribution with respect to part or all of an interest in a partnership include—

(i) The aggregate of the partners' section 1254 costs with respect to the natural resource recapture property immediately prior to the distribution; reduced by

(ii) The amount of any gain taken into account as ordinary income under section 751 by the partnership or the partners (as constituted after the distribution) on the distribution of the natural resource recapture property.

(2) *Aggregate of partners' section 1254 costs with respect to natural resource recapture property held by a partnership—*

(i) *In general.* The aggregate of partners' section 1254 costs is equal to the sum of each partner's section 1254 costs. The partnership must determine each partner's section 1254 costs under either paragraph (d)(2)(i)(A) (written data) or paragraph (d)(2)(i)(B) (assumptions) of this section. The partnership may determine the section 1254 costs of some of the partners under paragraph (d)(2)(i)(A) of this section and of others under paragraph (d)(2)(i)(B) of this section.

(A) *Written data.* A partnership may determine a partner's section 1254 costs by using written data provided by a partner showing the partner's section 1254 costs with respect to natural resource recapture property held by the

partnership unless the partnership knows or has reason to know that the written data is inaccurate. If a partnership does not receive written data upon which it may rely, the partnership must use the assumptions provided in paragraph (d)(2)(i)(B) of this section in determining a partner's section 1254 costs.

(B) *Assumptions.* A partnership that does not use written data pursuant to paragraph (d)(2)(i)(A) of this section to determine a partner's section 1254 costs must use the following assumptions to determine the partner's section 1254 costs:

(1) The partner deducted his or her share of deductions under section 263(c), 616, or 617 for the first year in which the partner could claim a deduction for such amounts, unless in the case of expenditures under section 263(c) or 616, the partnership elected to capitalize such amounts;

(2) The partner was not subject to the following limitations with respect to the partner's depletion allowance under section 611, except to the extent a limitation applied at the partnership level: the taxable income limitation of section 613(a); the depletable quantity limitations of section 613A(c); or the limitations of section 613A(d)(2), (3), and (4) (exclusion of retailers and refiners).

[T.D. 8586, 60 FR 2507, Jan. 10, 1995]

**§ 1.1254-6 Effective date of regulations.**

Sections 1.1254-1 through 1.1254-3 and § 1.1254-5 are effective with respect to any disposition of natural resource recapture property occurring after March 13, 1995. The rule in § 1.1254-1(b)(2)(iv)(A)(2), relating to a nonoperating mineral interest carved out of an operating mineral interest with respect to which an expenditure has been deducted, is effective with respect to any disposition occurring after March 13, 1995 of property (within the meaning of section 614) that is placed in service by the taxpayer after December 31, 1986. Section 1.1254-4 applies to dispositions of natural resource recapture property by an S corporation (and a corporation that was formerly an S corporation) and dispositions of S corporation stock occurring on or after