

is acquired from a decedent prior to death).

(d) *Property received in a like kind exchange or involuntary conversion*—(1) *General rule.* If natural resource recapture property is disposed of in a like kind exchange under section 1031 or involuntary conversion under section 1033, then immediately after the disposition the amount of section 1254 costs with respect to any natural resource recapture property acquired for the property transferred is an amount equal to—

(i) The amount of section 1254 costs with respect to the natural resource recapture property disposed of; minus

(ii) The amount of any gain taken into account as ordinary income under section 1254(a)(1) by the transferor upon the disposition.

(2) *Allocation of section 1254 costs among multiple natural resource recapture properties acquired.* If more than one parcel of natural resource recapture property is acquired at the same time from the same person in a transaction referred to in paragraph (d)(1) of this section, the total amount of section 1254 costs with respect to the parcels is allocated to the parcels in proportion to their respective adjusted bases.

(e) *Property transferred in cases to which section 1071 or 1081(b) applies.* Rules similar to the rules of section 1245(b)(5) shall apply under section 1254.

§ 1.1254-4 Special rules for S corporations and their shareholders. [Reserved].

§ 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