

Contribution Of Appreciated Property To A Partnership: More Than Just A Nice Credit To The Capital Account



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Make sure your partnership clients appreciate the consequences of contributing appreciated property.

IN HELPING CLIENTS WITH TRANSFERS of appreciated property to partnerships or limited liability companies that are partnerships for tax purposes, we often discuss the benefits of pass-through income taxation and the generally tax-free treatment of contributions of property to partnerships. Clients may also have the idea that distributions of property from partnerships are generally tax-free. We know, however, that a contribution of appreciated property—that is, property with a value in excess of its adjusted tax basis—has many consequences for partnership operations and distributions. This article reviews several perhaps less frequently discussed federal income tax consequences of the contribution of appreciated property to a partnership that may be important to our clients.

BACKGROUND • Contributions of property, even appreciated property, to a partnership are generally tax-free to the contributing partner. §721(a). (All section references are to the Internal Revenue Code, unless otherwise indicated.) The contributing partner receives a credit to his or her capital account for the contribution in the amount of the current value of the property. The exceptions to this tax-free treatment are contributions to partnerships that

are investment partnerships and some contributions of property subject to debt. A contribution of appreciated property to an investment partnership is treated as a sale of the property to the partnership by the contributing partner. §721(b). A contribution to any partnership of property subject to debt may result in an immediate taxable gain to the contributing partner if under the rules of partnership taxation governing liabilities, the contributing partner is deemed to have been relieved of an amount of liabilities in excess of his or her basis in the contributed property. §§752 and 731. For a contribution of property in exchange for a partnership interest that does not involve any recognition of gain by the contributing partner, the partnership takes a basis in the contributed property equal to the contributing partner's basis in the property, and the contributing partner takes a basis in his partnership interest equal to his or her basis in the contributed property. §§722 and 723.

Liquidating vs. Nonliquidating Distributions

A distribution of property, other than cash or marketable securities treated like cash, is generally tax-free to the partner receiving the distribution. §731. In the case of a nonliquidating distribution, the partner receiving the distributed property takes a basis in the property equal to the partnership's basis in the property (subject to a cap in the amount of the partner's basis in his or her partnership interest reduced by any money distributed). §732(a). For liquidating distributions of property (other than money) the rule is different. The partner receiving the property distributed in liquidation of his partnership interest takes a basis in the property equal to his or her interest in his or her partnership interest reduced by any money distributed. §732(b). There are also special rules that apply when property is distributed within two years of the partner's acquisition of his or her partnership interest by transfer and when "hot assets" are involved. §732(d) and (e).

A nonliquidating distribution of partnership property to a partner has the effect of reducing the partner's basis in his or her partnership interest by the amount of the partner's basis in the property distributed (and the amount of any money also distributed). §733. The partner's basis may not be reduced below zero.

Let's now look at what else a contribution of appreciated property means to a partnership and the partners. (Space does not permit a parallel discussion of the consequences of a transfer of depreciated property to a partnership. On that subject, see section 704(c)(1)(C).)

SECTION 704(c) AND ALLOCATION OF GAIN WITH RESPECT TO CONTRIBUTED PROPERTY

• Section 704(c)(1)(A) requires items of income, gain, loss, and deduction with respect to property contributed to a partnership by a partner to be shared among the partners to take into account any difference between the basis of the property to the partnership and the fair market value of the property at the time of the contribution. When a partnership receives a contribution of appreciated property from a partner, the partnership has property with a "built-in gain" in the amount of the excess of the fair market value of the property on contribution (the fair market value being its initial "book value" for partnership purposes) over its tax basis. (As used in this article, "book value" means book value as determined in accordance with section 704(b), not book value under GAAP or other financial accounting measures.) This initial built-in gain may be reduced over time by the excess of basis recovery deductions (e.g., depreciation) as calculated for "book" purposes over those same deductions as calculated for tax purposes. When the partnership sells this "section 704(c) property" and recognizes a gain, the built-in gain on the property must be allocated to the contributing partner. Treas. Reg. §1.704-3(b)(1). The contributing partner should know that responsibility for any income tax

attributable to this built-in gain sticks with him or her after the contribution.

Example: A and B form partnership AB and agree each will be allocated 50 percent of all partnership items. A and B also agree that allocations required by section 704(c) must be given effect. A contributes land with an adjusted tax basis of \$5,000 and a fair market value of \$10,000. B contributes \$10,000 cash. Two years later AB sells the land for \$30,000. A is allocated \$5,000 of (built-in) gain under section 704(c) and \$10,000 of (book) gain. B is allocated \$10,000 of (book) gain.

The regulations approve of three methods of allocating items of income, gain, loss, or deduction with respect to section 704(c) property: the traditional method, the traditional method with curative allocations, and the remedial allocation method. Under the traditional method, if the partnership sells section 704(c) property and realizes a gain, the built-in gain is allocated to the contributing partner. Treas. Reg. §1.704-3(b). This method works well when, as in the example, there is enough gain to allocate (i) the appropriate amount of book gain to the partners and (ii) the appropriate amount of built-in gain to the contributing partner. But what about other situations? Under the traditional method, there is a “ceiling rule.” The total income, gain, loss, or deduction allocated to the partners with respect to a property cannot exceed the total partnership income, gain, loss, or deduction with respect to that property for the year. Consider the following situation:

Example: A and B form partnership AB and agree each will be allocated 50 percent of all partnership items. A and B also agree that allocations required by section 704(c) must be given effect. A contributes land with an adjusted tax basis of \$5,000 and a fair market value of \$10,000. B contributes \$10,000 cash. Two years later AB sells the land for \$8,000.

AB has a tax gain of \$3,000, but a book loss of \$2,000. To take section 704(c) into account, A might be allocated \$5,000 of gain and \$1,000 of loss and

B might be allocated \$1,000 of loss. However, because of the ceiling rule, there is only \$3,000 of tax gain to allocate. There is no tax loss to allocate to the partners. As a result, after the sale there is still a disparity between A’s tax basis in A’s partnership interest (\$8,000) and A’s capital account balance (\$9,000). There is also a new disparity between B’s tax basis in B’s partnership interest (\$10,000) and B’s capital account balance (\$9,000).

Curing Disparities

Such disparity can be addressed by using the traditional method with curative allocations or the remedial allocation method. With the traditional method with curative allocations, the partnership makes “curative” allocations of *actual items* of income, gain, loss, or deduction that differ from the partnership’s allocation of the corresponding book item in the amount necessary to offset the effect of the ceiling rule for the year. Treas. Reg. §1.704-3(c). With the remedial allocation method, the partnership takes care of variations between tax and book allocations by *creating remedial items* of income, gain, loss, or deduction for tax purposes and allocating those items to the noncontributing partners *and creating offsetting remedial items* for tax purposes in the same amounts and allocating the offsetting items to the contributing partner. Treas. Reg. §1.704-3(d). Obviously, the partnership’s choice of allocation method for its section 704(c) property can have real tax consequences for the partners.

SECTION 704(c) AND ALLOCATION OF NONRECOURSE INDEBTEDNESS •

Increases in a partner’s share of partnership liabilities are treated as contributions of money by the partner to the partnership, and decreases in a partner’s share of partnership liabilities are treated as distributions of money from the partnership to the partner. §752(a) and (b). These deemed contributions and distributions affect the partner’s basis in his or her partnership interest. §§705, 722, 742 and 733.