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.

Deemed distributions may result in the partner's realization of gain. §731. Basis is important for many reasons, including section 704(d)'s limitation of losses by a partner's basis in his or her partnership interest. Accordingly, the allocation of partnership liabilities among the partners is of fundamental importance.

The regulations describe how partnership liabilities are allocated among the partners. Treas. Reg. §§1.752-2 (recourse liabilities) and 1.752-3 (nonrecourse liabilities). Section 704(c) figures prominently in the regulations' scheme of allocation of nonrecourse liabilities.

A partner's share of partnership nonrecourse liabilities is equal to the sum of (i) the partner's share of "partnership minimum gain," (ii) the amount of gain that would be allocated to the partner under section 704(c) if the partnership disposed of all partnership property subject to one or more partnership nonrecourse liabilities in full satisfaction of the liabilities (and for no other consideration), and (iii) the partner's share of "excess nonrecourse liabilities" (those partnership nonrecourse liabilities not allocated under tier (i) or tier (ii)). Treas. Reg. §1.752-3(a). For a definition of "partnership minimum gain" see Treas. Reg. §1.704-2(d). For the determination of a partner's share of partnership minimum gain, see Treas. Reg. §1.704-2(g)(1). As a general rule, a partner's share of excess nonrecourse liabilities is determined by the partner's share of partnership profits. The regulations permit the partnership agreement to specify profits interests for this purpose as long as the interests specified are reasonably consistent with allocations of some other item of partnership gain or loss that has substantial economic effect (under the section 704(b) regulations). The regulations also permit excess nonrecourse liabilities to be allocated among the partners in accordance with the manner in which it is reasonably expected that the deductions attributable to the nonrecourse liabilities will be allocated. The partnership may, in addition, first allocate an excess nonrecourse liability to a partner up to the amount of built-in gain that is allocable to the partner on section 704(c) property subject to the nonrecourse liability to the extent that such built-in gain exceeds that portion of the 704(c) gain allocated in accordance with tier (ii) with respect to such property. Treas. Reg. §1.752-3(a)(3). If this method of allocation of excess nonrecourse liabilities based on built-in gain on section 704(c) property is used and the entire amount of the excess nonrecourse liability is not allocated to the contributing partner, the partnership must allocate the remaining excess nonrecourse liability under one of the other methods specified in the regulations.

Example: A and B form partnership AB. A contributes $50 cash in exchange for a 50 percent percent interest. B contributes property P in exchange for a 50 percent interest. Property P has a fair market value of $130 and an adjusted tax basis of $70 and is subject to a nonrecourse liability of $80. All of the built-in gain of $60 is section 704(c) gain allocable to B. The amount of the nonrecourse liability ($80) is less than the book value of property P, so there is no partnership minimum gain. Accordingly, no portion of the liability is allocated under tier (i). If Property P were sold in exchange for the satisfaction of the partnership's nonrecourse liability, B would be allocated $10 of gain under section 704(c) ($80 liability less $70 basis). Accordingly, under tier (ii), B will be allocated $10 of the liability. There is $70 of excess nonrecourse liability ($80 liability less $10 allocated under tier (ii)) to allocate under tier (iii). AB determines to allocate the $70 of excess nonrecourse liability to the partners up to their share of the remaining section 704(c) gain on Property P, with any remaining amount of the liability being allocated equally to A and B consistent with their equal interests in partnership profits. B has $50 of remaining section 704(c) gain, and thus will be allocated $50 of the liability in accordance with this gain. The remaining $20 is divided equally between A and B. Accordingly, the overall allocation of the $80 nonrecourse liability is as follows:

Partner	Tier (i)	Tier (ii)	Tier (iii)	Total
A	$0	$0	$10	$10
B	$0	$10	$60	$70

SECTION 704(c) AND ALLOCATION OF DEPRECIATION DEDUCTIONS • The contributing partner may be surprised to learn that after his or her contribution of appreciated property to the partnership, some or all of his or her proportionate share of the depreciation deductions with respect to the property is allocated to the other partners. Section 704(c) deals with allocation of items of deduction as well as items of gain. For section 704(c) property subject to depreciation or any other type of cost recovery, the allocation of cost recovery deductions attributable to the 704(c) property must take into account the built-in gain on the property. Allocations of depreciation deductions, for example, to the noncontributing partners with respect to section 704(c) property generally must, to the extent possible, equal the book allocations to those partners. When the section 704(c) property has a higher book value than basis, as will be the case when the contributed property is appreciated, each year's book depreciation (which is based on its book value) will exceed each year's tax depreciation (which is based on its tax basis). What this means is that the tax deductions for depreciation attributable to the contributed appreciated property will be allocated first to the noncontributing partners to match the book deductions for depreciation attributable to such property.

Example: A and B form partnership AB and agree each will be allocated 50 percent of all partnership items. A contributes depreciable property with an adjusted tax basis of $5,000 and a fair market value of $10,000. B contributes $10,000 cash. The property is depreciated using the straight-line method over a 10-year period. B is entitled to a depreciation deduction of $500 per year for book and tax purposes. AB's total depreciation deduction for the property for tax purposes is $500 per year. All of AB's $500 depreciation deduction for tax purposes is allocated to B each year. None is allocated to A.

The catch is that the total depreciation deduction that can be allocated to the partners with respect to a property cannot exceed the total partnership depreciation deduction with respect to that property for the taxable year. This is an application of the "ceiling rule."

Example: Assume the same facts as previous example except the property has an adjusted tax basis of $4,000. AB's total depreciation deduction for the property for tax purposes is $400 per year. All of AB's $400 depreciation deduction for tax purposes is allocated to B each year, but it is not enough to match AB's allocation of $500 of book depreciation deduction to B each year. The allocation of tax depreciation to B has been limited by the ceiling rule. (For a more elaborate treatment of these facts see Example 1 at section 1.704-3(b)(2) of the regulations.)

Selecting A Method

We have reviewed the three methods of allocating items of income, gain, loss, and deduction attributable to section 704(c) property: the traditional method, the traditional method with curative allocations, and the remedial allocation method. In the context of depreciation deductions, the traditional method is satisfactory when the allocation of the partnership's depreciation deduction for the contributed property is not limited by the ceiling rule. Treas. Reg. §1.704-3(b). If the ceiling rule prevents the noncontributing partners from being allocated tax deductions for depreciation that equal their book deductions for depreciation, the partnership may use the traditional method with curative allocations or the remedial allocation method. As noted above, with the traditional method with curative allocations, the partnership makes "curative" allocations of actual items of income, gain, loss, or deduction for tax purposes 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).

DISGUISED SALES • A partner who plans to contribute appreciated property to a partnership should know the circumstances under which the IRS may recharacterize his or her contribution as a taxable sale of all or part of the property to the partnership. Section 707(a)(2)(B) provides, in part, that if (i) a partner transfers property to a partnership, (ii) there is a related transfer of money (or other consideration) by the partnership to the partner, and (iii) the two transfers, when viewed together, are properly characterized as a sale of the property, the transfer will be treated as a sale of the property. (Section 707(a)(2)(B) is also broad enough to cover disguised sales of partnership interests. The Treasury proposed, and later withdrew, regulations under that section dealing with disguised sales of partnership interests. The proposed regulations had much in common with the regulations earlier adopted to deal with disguised sales of property to partnerships.)

Example: A transfers Property X to partnership AB in exchange for an interest in the partnership. Property X has a fair market value of $4 million and an adjusted tax basis of $1.2 million. Immediately afterwards AB transfers $3 million in cash to A. If the transfers are properly characterized as a sale, A is considered to have sold a portion of Property X with a value of $3 million to AB for cash. A must recognize $2.1 million of gain ($3 million realized less $900,000 adjusted tax basis ($1.2 million multiplied by $3 million/$4 million)). A is considered to have contributed $1 million of the fair market value of the property (with an adjusted tax basis of $300,000) to AB in A's capacity as a partner. Treas. Reg. §1.707-3(f), Example 1.

Under the regulations, a transfer of property by a partner to a partnership and a transfer of money (or other consideration) by the partnership to the partner is a sale of the property, in whole or in part, if (i) the transfer of money (or other consideration) would not have been made but for the transfer of the property, and (ii) if the transfers are not simultaneous, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations. Treas. Reg. §1.707-3(b)(1). The regulations provide that the determination of whether the transfers should be treated as a sale is made based on all the facts and circumstances and describe certain facts and circumstances that tend to prove the existence of a sale. Treas. Reg. §1.707-3(b)(2).

More importantly, the regulations provide that transfers made within two years of each other are presumed to be a sale of the property and that transfers made more than two years apart are presumed not to be a sale. Treas. Reg. §1.707-3(c) and (d). It does not matter for these purposes in what order the transfers are made.

But what about normal partnership distributions within two years of a transfer of appreciated property to the partnership? Under the regulations, "reasonable guaranteed payments for capital," "reasonable preferred returns" and "ordinary cash flow distributions" (each as defined in the regulations) are generally not treated as part of a sale. Treas. Reg. §1.707-4. Certain reimbursements of preformation expenditures are also not treated as part of a sale.

Complicating the matter further, the regulations provide that if a partnership assumes or takes property subject to a liability of a partner, the partnership may be treated for purposes of the disguised sale analysis as transferring money to the partner to the extent that the amount of the liability exceeds the partner's share of the liability immediately afterwards. Treas. Reg. §1.707-5. For purposes of this calculation, the partner's share of a nonrecourse liability is determined in a special way. It is determined by applying the percentage used to compute the partner's share of excess nonrecourse liability under Treas. Reg. §1.752-3(a)(3), not under the usual three-part test of the section 752 regulations. (Similar rules apply if a partner transfers property to a partnership and the partnership incurs a liability, the proceeds of which are distributed to the partner within 90 days. Treas. Reg. §1.707-5(b).) However, a partnership's assumption or taking property subject to a "qualified liability" of a partner is not treated as part of a sale (unless the transfer of property is otherwise treated as a sale). Treas. Reg. §1.707-5(a)(5).

A qualified liability includes:

- A liability incurred more than two years before the earlier of the date the partner agrees to transfer the property to the partnership or the date of the transfer that has been an encumbrance on the property for the whole two-year period;
- A liability not incurred in anticipation of the transfer that has been an encumbrance on the property since it was incurred;
- A liability that is allocable to capital expenditures with respect to the property; and
- A liability incurred in the ordinary course of the trade or business in which the property was used but only if all the material assets of the trade or business are transferred.

In addition, if the liability is recourse to the partner, the amount must not exceed the fair market value of the property (less certain other senior liabilities). The regulations provide that if the liability has been incurred within two years, it is presumed to have been incurred in anticipation of the transfer unless it was for capital expenditures or incurred in the ordinary course. Treas. Reg. §1.707-5(a)(6) and (7).

DISTRIBUTIONS OF CONTRIBUTED PROPERTY • A partner who contributes appreciated property to a partnership should also know that he/she may be taxed if the partnership distributes the property to another partner within seven years of the contribution. Under section 704(c)(1)(B), a partner who contributes appreciated property to a partnership may be required to recognize gain on the distribution of the property to another partner within seven years of its contribution to the partnership. The amount of the gain that the partner must recognize is equal to the gain that would have been allocated to him or her under section 704(c)(1)(A) if the distributed property had been sold by the partnership to the distributee partner for its fair market value at the time of the distribution.

Example: A, B, and C form partnership ABC as equal partners. A contributes \$10,000 cash and Property A (land) with a fair market value of \$10,000 and adjusted tax basis of \$4,000. B contributes \$10,000 cash and Property B (land) with a fair market value of \$10,000 and adjusted tax basis of \$10,000. C contributes \$20,000 cash. After six years ABC distributes Property A and Property B to C in complete liquidation of C's interest in the partnership. On these facts, Property B has built-in gain under section 704(c) of \$6,000 and Property C has no built-in gain. A must recognize \$6,000 of gain on the distribution of Property A to C. B does not recognize any gain or loss on the distribution of Property B to C. Treas. Reg. §1.704-4(a)(5), Example 1.

The amount of gain the contributing partner must recognize may be influenced not only by changes in the fair market value of the property but also by post-contribution depreciation deductions (and the method chosen for allocating those deductions and other items of income, gain, and loss with respect to 704(c) property). See Examples 2 and 3 at Treas. Reg. §1.704-4(a)(5). The character of the contributing partner's gain may be influenced by the type of the property and the identity of the distributee partner. Section 1.704-4(b) of the regulations has an example of a distribution of a capital asset to a partner resulting in ordinary income to the contributing partner because the distributee partner held more than 50 percent of the partnership's capital or profits and the distributed property was not a capital asset in the hands of the distributee partner. The regulation cites section 707(b)(2).

Section 704(c)(1)(B) does not apply to:

- Deemed distributions in section 708(b) partnership terminations;
- Certain liquidating distributions;
- A partnership's transfer of all of its assets and liabilities to another partnership (when the transferring partnership also liquidates);
- The incorporation of a partnership (so long as the partnership property is not actually distributed) when the partnership is also liquidated; or
- Certain distributions of undivided interests to the contributing partner. Treas. Reg. §1.704-4(c)(2)-(6).

(Section 1.704-4(c)(4) of the proposed regulations deals with certain partnership mergers.) The statute also contains an interesting provision for a type of like-kind exchange treatment when property is distributed to a noncontributing partner and within certain time limits the partnership also distributes other property of like kind to the contributing partner. §704(c)(2); Treas. Reg. §1.704-4(d)(3).

DISTRIBUTIONS OF OTHER PROPERTY TO THE CONTRIBUTING PARTNER • A partner who contributes appreciated property to a partnership may also be taxed if the partnership distributes other property to him or her within seven years of his or her contribution. Under section 737, a partner to whom a partnership distributes property must recognize gain in an amount equal to the lesser of (i) the "excess distribution" or (ii) the partner's "net precontribution gain." Gain recognized under section 737 is in addition to any gain recognized under section 731 (concerning distributions of cash). §737(a). The excess distribution is the amount by which the fair market value of the distributed property (other than money or marketable securities treated like money) exceeds the distributee partner's adjusted tax basis in his or her partnership interest. The partner's net precontribution gain is the net gain the partner would have recognized under section 704(c)(1)(B) if all property that he or she contributed to the partnership within seven years of the distribution (and that was still held by the partnership immediately before the distribution) had been distributed to another partner. When a partner recognizes gain under section 737, the partnership makes adjustments to the basis of the contributed property that was taken into account in the section 737 calculations. §737(c)(2); Treas. Reg. §1.737- 3(c).

Example: A, B, and C form partnership ABC as equal partners. A contributes Property A (land) with a fair market value of $30,000 and adjusted tax basis of $20,000. B contributes Property B (land) with a fair market value and adjusted tax basis of $30,000. C contributes Property C (land) with a fair market value and adjusted tax basis of $30,000. Five years later Property B is distributed to A in complete liquidation of A's interest in ABC. Assume A's adjusted basis in A's partnership interest is still $20,000 at the time of the distribution and that the fair market value of Property B is $40,000. The amount of the excess distribution is $20,000 (the difference between the fair market value of Property B and A's basis in A's partnership interest). A's net precontribution gain is $10,000 (the difference between the book value of Property A and its adjusted tax basis to the partnership at the time of the distribution). A recognizes gain of $10,000 under section 737 on the distribution, the lesser of the excess distribution and A's net precontribution gain.

Although for the sake of simplicity the example deals with nondepreciable properties, in addition to the fair market values of the properties involved, any post-contribution depreciation deductions attributable to the property contributed by the partner within seven years of the distribution must be taken into account in the section 737 gain calculations, as must the method chosen for allocating items of income, gain, loss, and deduction with respect to contributed property. See Treas. Reg. §1.737-1(e), Example 1. The character of the gain recognized under section 737 is determined by the character of the partner's net precontribution gain (as if the contributed property had been sold to an unrelated third party). §737(a); Treas. Reg. §1.737-1(d).

Section 737 does not apply:

- To distributions of property contributed by the distributee partner (§737(d)(1);
- To the extent section 751(b) (concerning distributions of "hot assets") applies (§737(d)(2));
- To deemed distributions in section 708(b) partnership terminations (Treas. Reg. §1.737-2(a));
- To certain transfers of partnership property to another partnership (Treas. Reg. §1.737-2(b)); or
- To the incorporation of a partnership (so long as the partnership property is not actually distributed) when the partnership is also liquidated (Treas. Reg. §1.737-2(c)).

It is good to keep in mind that both section 704(c)(1)(B) and section 737 may apply to the same distribution when the distributee partner has contributed appreciated property to the partnership and the property being distributed was contributed by another partner with built-in gain.

SECTION 743(b) ADJUSTMENTS TO BASIS

• After the sale of a partnership interest or a partner's death, section 743(b) requires a partnership with a section 754 election in effect (or with a substantial built-in loss) to (i) increase the adjusted basis of partnership property by the excess of the basis to the transferee partner of his or her interest in the partnership over his or her proportionate share of the adjusted basis of the partnership's property, or (ii) decrease the adjusted basis of partnership property by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership's property over the basis of his or her interest in the partnership. (The 743(b) adjustment is an adjustment to the basis of the partnership's property only with regard to the transferee partner.) The statute requires that section 704(c) be taken into account. Under the regulations, determining the transferee partner's share of the adjusted basis of the partnership's property involves determining the amount of tax gain or loss that would be allocated to the transferee partner in a hypothetical sale by the partnership of all of its assets. Treas. Reg. §1.743-1(d). The amount of gain will include any gain that would be allocated to the transferee partner under section 704(c).

What's A Partner To Do?

A partner contributing appreciated property to a partnership should consider more than the value the property will be given for purposes of crediting his or her capital account and determining his or her share of the partnership's profits. The partner should also be concerned with the method the partnership will use to allocate items of income, gain, loss or deduction with respect to the property. If the partnership will have nonrecourse liabilities secured by the property, the partner should determine how the partnership will allocate any excess nonrecourse liability. If the partner does not control the partnership, he or she may wish to secure agreements with the other partners on these matters. The contributing partner will also want to analyze carefully distributions or planned distributions to himself or herself within two years of the contribution for possible problems with the contribution's recharacterization as a disguised sale. This analysis should take into account debt to which the contributed property is subject. The contributing partner may want an agreement with the other partners that distributions within the two-year period following the contribution will conform to the safe harbors provided in the regulations.

For a full seven years after the contribution, the contributing partner will need to be alert to any plan for the partnership's distribution of the contributed property to another partner or for the partnership's distribution of the other property to him or her, either of which could trigger recognition of the built-in gain on the contributed property. If the contributing partner does not control the partnership, he or she may want an agreement with the other partners prohibiting any such distributions without his or her consent.

Finally, the contributing partner and the partnership need to understand that any built-in gain may be a persistent feature of the partnership. For example, if the partnership is incorporated, a question arises. Subchapter C and Subchapter S of the Code have no provisions like section 704(c). The partners may need to agree how, if at all, the shift of built-in gain from the contributing partner to the corporation should be taken into account in the determination of the allocation of shares in the corporation.

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