

## **Contributing a business with appreciated assets to a partnership.**

Dear Reader:

You recently told me that you are considering contributing your business to a partnership in exchange for an interest in the partnership. You also told me that some of the business assets have appreciated substantially and that you would like to defer paying taxes on this gain for as long as possible. This letter will give you some basic information about the tax issues that will have to be dealt with.

Although gain or loss is generally not recognized when property is contributed to a partnership, there are several important exceptions to this rule. One of the exceptions you have to watch out for is the one that applies to so-called "disguised sales." IRS will sometimes use these rules to find a sale of property to a partnership where no sale was really intended. For instance, if you transfer property to a partnership, and at some time within the next two years the partnership makes a cash distribution to you, there is a presumption that the contribution and the distribution should be treated as a "disguised sale" unless you can prove the contrary, which may not be easy. "Disguised sale" treatment for a contribution of appreciated property will mean taxable gain.

For purposes of the "disguised sale" rules, the assumption of liabilities is treated as a cash distribution, unless the debt in question is what the tax code calls "qualified liability." (Generally speaking, a debt is a "qualified liability" if it was incurred more than two years before the transfer, or if it can be shown that the debt wasn't incurred in anticipation of the transfer, or if certain other special requirements are met.) Thus, if the partnership assumes certain liabilities of your business that are not "qualified liabilities," the assumption of the liabilities may cause your contribution to be treated as a sale.

Even if the liabilities of your business are "qualified liabilities" and your contribution is not treated as a sale, you may recognize gain as a result of the partnership's assumption of these liabilities if the liabilities assumed exceed the basis of the assets you contribute plus your share of the partnership's liabilities. Because of this, it may be important to ensure that you will be allocated a sufficient portion of the partnership liabilities so that you will not recognize any gain on the contribution. The rules for allocating partnership liabilities are complicated and depend on whether the liabilities are recourse or nonrecourse. I would need more information about the partnership in order to determine the best way of having enough of the partnership's liabilities allocated to you.

Although you will have contributed your business assets to the partnership, the tax code requires that so-called "built-in gain or loss" on assets that you contribute be allocated to you and not to the other partners. (Generally speaking, "built-in gain or loss" is the difference between the fair market value and basis of contributed property at the time of contribution.) The rules that apply here are complex and can affect in many ways how partnership items, including depreciation, are shared among the partners. The partnership may have to adopt some special accounting rules to cope with the requirements imposed by the tax code on "built-in gain and loss." This is something we will have to discuss.

In connection with "built-in gain or loss," there is one very important step we can take to keep you from being hit with taxes any sooner than you have to be. Since built-in gain on contributed assets must be allocated to you, and not to the other partners, if the partnership were to sell the assets you contributed, you might have to recognize built-in

gain on them at the time of the sale. Because of this, you may want to get the partnership to agree that it will not sell the contributed assets for a certain period in order to ensure that the gain will not have to be recognized by you for that period.

If you would like my help in dealing with any of the above issues or any other issues that may arise in connection with your plans to contribute your business to a partnership, please give me a call.

