

## Contributing appreciated property to a partnership

Dear Reader:

I am writing to explain the tax consequences of a partner's contribution of appreciated ("gain") property to a partnership. (For simplicity, I assume that there are no liabilities on the property, and that the contribution is respected as such and not recharacterized under special rules, e.g., as a disguised sale.)

The contributing partner doesn't report the "built-in-gain" on the property when it's contributed. The partnership takes the same basis in the property that the partner had, and the partner's basis in the partnership interest received for the property is equal to the pre-contribution basis in the property.

*Example (1).* John contributes land with a basis of \$10,000 and a value of \$16,000 to a partnership in exchange for a 50% partnership interest. John doesn't recognize gain. The partnership's basis in the land and John's basis in his interest are both \$10,000.

Although the gain isn't recognized by the contributing partner at the time of the contribution, the parties must keep track of the built-in gain so it can be specially allocated to the contributing partner when the partnership sells it. Only the gain in the property when it's contributed is specially allocated. Any later, additional gain is allocated according to the partnership agreement.

*Example (2).* In Example (1), the partnership sells the property for \$18,000, incurring a gain of \$8,000, since its basis was \$10,000. The \$6,000 of built-in gain is allocated to John. The remaining \$2,000 of gain (representing appreciation that occurred while the partnership owned the property) is allocated equally between John and the other partners.

The tax treatment can get complex if the property *drops* in value in the partnership's hands. In this case, gain is still allocated to the contributing partner, but the partnership has several options regarding the "loss" (drop in value).

*Example (3).* The facts are the same as in the previous examples except that the property is sold for only \$14,000. That is, the property dropped \$2,000 in value in the partnership's hands. However, since the partnership's basis in the property was \$10,000, there is still \$4,000 of partnership gain on the sale.

Different approaches can be taken. Under the traditional method, the entire \$4,000 of gain is allocated to John, but since there is no partnership loss, there are no further allocations. The other partners suffer under this approach because they don't receive a loss allocation to reflect their share of the actual drop in value of the property in the partnership's hands.

Under an alternative approach, the entire \$6,000 of built-in gain is allocated to John. In this case, however, \$1,000 in loss is also allocated to John and \$1,000 to the other partners to reflect the \$2,000 drop in value since the contribution. Accordingly, John reports a net gain of \$5,000 and to the other partners their \$1,000 loss.

Note that we have been discussing a situation involving built-in *gain* so far. However, the rules are similar regarding special allocations for built-in losses. The loss built in to the

property at the time of the contribution is specially allocated to the contributing partner when it is sold by the partnership.

Please note as well that if property with built-in gain or loss is *distributed* (as opposed to sold) within seven years of its contribution to the partnership, from the contributing partner's standpoint, the property is treated as sold by the partnership. Thus, the built-in gain or loss will be taxed to the contributing partner at this point. This rule doesn't apply if the distribution is made to the contributing partner.

If a partner contributes appreciated property to a partnership and within seven years of the contribution, while the partnership holds the contributed property, he receives a distribution of other appreciated property, the partner recognizes the gain on the contributed property that he would have recognized if it had been sold by the partnership. However, the gain is limited to the excess of the fair market value of the property distributed to the partner over his adjusted basis in the partnership immediately before the distribution.

**Depreciable property** The tax treatment grows even more complex if the contributed property is depreciable. Special allocations must be made to ensure that the noncontributing partners don't lose out on depreciation deductions by virtue of the lower partnership basis in the asset.

*Example (4).* Karen contributes a machine to an equal partnership with Alex. Her basis was \$8,000 and the machine's value is \$10,000. Alex contributes \$10,000. The partnership is entitled to a 10% depreciation deduction on the machine. This comes to an \$800 deduction based on the \$8,000 basis. However, Alex is allocated a \$500 share to reflect his 50% interest in the machine's \$10,000 value (50% of 10% of \$10,000). The remaining \$300 is allocated to Karen. If the machine's basis in *Example (4)* were \$4,000, the total partnership depreciation would be \$400, which is insufficient to provide Alex with the \$500 of depreciation he should receive. Here, the partnership has a choice. It can follow the traditional method under which Alex receives only the \$400 of annual depreciation. Or, it can use the traditional method and make "curative allocations" of tax depreciation to Alex from other partnership properties. Alternatively, it can use a "remedial allocation method" under which it *creates* a \$100 item of deduction and allocates it to Alex while at the same time creating an offsetting item of income and allocating it to Karen.

I hope the above succeeds in outlining for you some of the special tax concerns involved when a partner contributes property to the partnership with a built-in gain or loss. This area has grown into one of the more complex areas in partnership taxation.

