Articles + Publications | June 7, 2016

Partnership Contributions That Trigger Gain? The IRS Says 'Yes'

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For most of the past decade, contributions to partnerships (including LLCs taxed as partnerships) have been non-recognition events under section 721(a).[1] Thus, partners did not have to recognize gain on the contribution of property to a partnership, even if the property had built-in gain. However, in August 2015, the Internal Revenue Service (IRS) changed the status quo with Notice 2015-54 (the Notice). The Notice announced that the IRS intends to issue regulations that will require gain recognition on the transfer of property to a partnership in certain situations. Even though the regulations have not been issued, the intended rules will apply to contributions to a partnership beginning on the date the Notice was published — August 6, 2015.

Background

Prior to repeal in 1997, the Code generally imposed a 35 percent tax on the gain inherent in appreciated property transferred by a U.S. person to a foreign partnership. Due to enhanced information reporting obligations enacted in 1997, Congress repealed this tax.[2] However, Congress also provided section 721(c), which allowed the Department of the Treasury (Treasury) to provide regulations requiring gain recognition if it determined that they were necessary to prevent inappropriate results.

Treasury issued no regulations requiring gain recognition on the contribution of property to a partnership for the next eight years. In August 2015, Treasury and the IRS decided to use the authority provided in section 721(c) to take action.

According to the Notice, Treasury and the IRS are aware of situations in which U.S. taxpayers contribute property with built-in gain to a partnership, and the partnership then allocates income or gain from the contributed property to a foreign partner that is not subject to U.S. tax. Moreover, these partnerships do not apply allocation methods, one of which is referred to as the "remedial method,"[3] to prevent shifting tax consequences among partners with respect to any built-in gain or loss on property contributed to the partnership. This effectively shifts the gain from a U.S. partner to a foreign partner, who may not be subject to U.S. tax. In order to ensure gain does not escape the United States untaxed, Treasury and the IRS will use their authority under section 721(c) to issue regulations that prevent the use of a partnership to shift gain to a foreign person in certain situations.

Future Regulations (Applicable Now) Will Override General Non-Recognition Treatment for Certain Contributions

The IRS intends to issue regulations requiring the recognition of gain on transfers of property to a partnership.

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Unless a partnership adopts the “Gain Deferral Method” (described below), the regulations will apply if the following three requirements are met:

1. The transferor partner must be a U.S. person who is not a domestic partnership (the Transferor).
2. The Transferor must contribute property with more than $20,000 built-in gain that is not a cash equivalent or a security (Section 721(c) Property).
3. The contribution must be made to a partnership, whether domestic or foreign, in which (a) the Transferor is directly or indirectly related to foreign partners and (b) the Transferor owns, in conjunction with any related parties, more than 50 percent of the interests in partnership capital, profits, deductions or losses.

In general, if these three requirements are met, then the Transferor must recognize gain on his or her contribution to the partnership.

Notwithstanding the general rule, the IRS plans to adopt a *de minimis* rule that continues tax-free treatment if the amount of built-in gain contributed by such U.S. persons and allocated to foreign partners is less than or equal to $1 million and the partnership is not applying the Gain Deferral Method to any prior contributions.

Example

USCo is a domestic corporation that developed a widget patent. USCo wholly owns FCo, a foreign corporation, that produces gadgets. With their combined expertise, USCo and FCo think they will be successful at widget production. USCo and FCo form a new partnership, XYZ, for the widget production business. FCo contributes cash of $1.5 million to XYZ, and USCo contributes a widget patent with a fair market value of $1.5 million and an adjusted basis of $0. Prior to August 6, 2015, neither USCo and nor FCo would recognize gain on their contributions to XYZ. However, now, unless XYZ adopts the Gain Deferral Method, USCo will have to recognize the gain inherent in the patent because USCo (i) is a U.S. person who is (ii) contributing Section 721(c) Property, (iii) to a partnership in which USCo is related to a foreign partner, and together they own all of XYZ.

Gain Deferral Method

If adopted by a partnership, the Gain Deferral Method will prevent the immediate recognition of gain on the contribution to the partnership, but will require the U.S. transferor to recognize built-in gain over time (generally, over the period of the useful life of the contributed property).

To use the Gain Deferral Method, the partnership must comply with the following five requirements:

1. The remedial allocation method is adopted for built-in gain for all Section 721(c) Property.
2. During any tax year in which there is remaining built-in gain in the Section 721(c) Property, the partnership allocates all items of income, gain, loss and deduction with respect to that Section 721(c) Property in the same proportion (*i.e.*, items of income from the property must be allocated in the same proportion as items of deduction).
3. Certain reporting requirements are satisfied.
4. The U.S. transferor recognizes any remaining built-in gain with respect to Section 721(c) Property if there is an acceleration event.
5. The Gain Deferral Method is adopted for all subsequently contributed Section 721(c) Property until five years after the initial contribution or there is no built-in gain remaining.

Additionally, the U.S. transferor (and, in certain cases, the partnership) must extend the statute of limitations with respect to all items related to the Section 721(c) Property for eight years following the contribution.

Requirement #1: The requirement to use the remedial method means that U.S. transferors of Section 721(c) Property will be allocated income in each year of the partnership until it has recognized the entire amount of the built-in gain existing as of the time of the contribution. Thus, although the use of the Gain Deferral Method prevents recognition of all built-in gain at the time of the contribution, the Gain Deferral Method will require that built-in gain be recognized over time.

Requirement #4: An "acceleration event" is any transaction that would defer or reduce the amount of remaining built-in gain the U.S. transferor would recognize under the Gain Deferral Method. For example, a transfer by the U.S. transferor of its interest in the partnership generally is an acceleration event. However, an acceleration event will not occur if the U.S. transferor transfers an interest in the partnership to a lower-tier partnership or a domestic corporation in a transaction where the transferor's basis is determined on a carryover basis.

Example (cont'd): If XYZ, the partnership from the above example, adopts the Gain Deferral Method, USCo will not have to recognize the $1.5 million built-in gain on the contribution of the patent to XYZ. Assuming the patent has a 10-year useful life, XYZ will have a $150,000 amortization deduction annually. Applying the remedial method, USCo will recognize $150,000 notional income, and FCo will have a $150,000 deduction for the 10-year life of the patent. Thus, USCo will recognize the entire built-in gain on the Section 721(c) Property contributed to XYZ but will not have to recognize that gain immediately on contribution.

Pepper Perspective

These new regulations will have a direct impact on the formation of partnerships in the international context. U.S. partners contributing property with built-in gain to a partnership with a related foreign partner should closely analyze these regulations to determine if gain is required to be recognized or whether the Gain Deferral Method may be applied to defer such recognition. This is particularly pertinent to contributions to a partnership of intangible assets (such as intellectual property, goodwill and going concern value), which often have little or no basis.

Endnotes

[1] All references to sections in this article are to sections in the Internal Revenue Code of 1986 as amended (the Code).

[2] Staff of the Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1997, Part Two: Taxpayer Relief Act of 1997 (H.R. 2014) (Dec. 19, 1997).

[3] Generally, the remedial method allows partnerships to create notional items of tax loss or deduction to allocate to partners that did not contribute appreciated property to match their allocable share of economic loss. To offset these notional items of loss or deduction, the partnership simultaneously creates notional items of taxable income that are allocated to the partner that contributed appreciated property. According to the Notice, this method "ensure[es] that pre-contribution gain from contributed property is properly taken into account by the contributing

partner."

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