Tax Tip

Do Not Overlook the Impact of the Character Freezing Provisions on Real Estate Transactions by or with a Passthrough Entity

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As we are often reminded, whether property is held by a taxpayer primarily for sale to customers in the ordinary course of such taxpayer's trade or business, thus rendering the property so-called "dealer property," is one of the most frequently litigated issues in the tax law. A plethora of cases addressing this issue has made it clear that the distinction between investment property taxed at capital gains rates and dealer property can be difficult to discern. Given the nature of this "old, familiar, recurring, vexing and oft-times elusive problem,"[1] it is sometimes easy to overlook provisions of the Code and regulations that freeze the character of an asset in the hands of a taxpayer or passthrough entity who or which holds such asset as dealer property when that asset is either transferred by the taxpayer to a passthrough entity in a nonrecognition transaction or is distributed by a passthrough entity to one or more of its partners or shareholders.

As a general rule, the determination of whether real property held by a partnership is dealer property is made at the partnership level.[2] The same general rule also applies to an S corporation.[3] Notwithstanding these general rules, the Code and regulations address several situations that override this entity-level examination and result in character freezing at a different level. These situations require a taxpayer's awareness when engaging in a real estate transaction involving a passthrough entity. For example, if property that is dealer property or is otherwise treated as an item of inventory, as defined in Code Sec. 751(d),[4] in the hands of a partner is contributed by such partner to a partnership in a Code Sec. 721 nonrecognition transaction, and the partnership subsequently has a recognized gain or loss from the sale of such property within five years of the date it was contributed, such gain or loss will be ordinary in character. This mandatory characterization rule will apply without regard to the partnership's intent in accepting the contributed property or its intended purpose for holding and operating the property thereafter. It should also be noted that the gain or loss that is subject to the mandatory characterization rule under Code Sec. 724(b) is *not* limited to the amount of built-in gain or loss at the time of contribution. Accordingly, under Code Sec. 724(b), while an ordinary loss on the disposition of dealer property contributed to a partnership may be advantageous, a partnership planning to dispose of contributed dealer or other inventory property that has a value in excess of its tax basis must be ever mindful of the five-year anniversary on which the property was contributed.

Similarly, Code Sec. 735(a)(2) acts as the flip side of Code Sec. 724(b) and freezes the character of certain assets held by a partnership when they are distributed out to one or more of the partners. If an asset that constitutes dealer property, or is otherwise treated as an item of inventory as defined in Code Sec. 751(d),[5] in the hands of the partnership is distributed to a partner and such partner recognizes a gain or loss from the sale of such asset within five years from the date it was distributed, such gain or loss will be characterized as ordinary.[6] Thus, the five-year anniversary of the distribution date of property that is dealer property or is an inventory item in the hands of the partnership should be carefully monitored when the distributee partner later decides to sell such property.

[T]axpayers should be mindful of whether property contributed to a passthrough entity or distributed from a passthrough entity constitutes dealer property with respect to the contributing partner or shareholder or the distributing partnership or corporation.

Although not applicable to dealer property, it is important to note that both Code Sec. 724 and Code Sec. 735 also contemplate dispositions of "unrealized receivables" as defined under Code Sec. 751(c). Under Code Sec. 724(a), gain or loss recognized by a partnership upon the disposition of property that was an unrealized receivable in the hands of the contributing partner immediately prior to contribution is characterized as ordinary income or loss. Similarly, under Code Sec. 735(a)(1), if a partnership distributes an asset that constitutes an unrealized receivable to a partner, any gain or loss recognized by such distributee partner from a taxable sale of such asset will be ordinary in nature.[7] Neither Code Sec. 724(a) nor Code Sec. 735(a)(1) includes a five-year time limitation on the period that the unrealized receivable's character is frozen, meaning gain or loss on the disposition of the unrealized receivable is ordinary in nature regardless of when the asset is sold.

In addition to partnerships, character-freezing rules also apply to S corporations. Under Code Sec. 1366(b) and Reg. §1.1366-1(b)(1), if the sale of an asset by an S corporation results in long-term capital gain, each shareholder's allocable share of such gain will retain its character as long-term capital gain even though such shareholder may otherwise be deemed to be a dealer in such assets. Nevertheless, Reg. §1.1366-1(b)(2) contains an anti-abuse rule intended to prevent one or more shareholders who hold dealer property from contributing such property to an S corporation in a Code Sec. 351 nonrecognition transaction and thereafter cause the S corporation to sell the contributed property and report the gain as long-term capital gain. In such a case, gain on the sale by the S corporation is treated as ordinary income. Unlike Code Sec. 724(b) and Code Sec. 735(a)(2) discussed above, there is no five-year time limitation on sales to which Reg. §1.1366-1(b)(2) applies.

Conclusion

While historically the determination as to whether a particular piece of property constitutes dealer property has garnered much of the attention, consideration should also be given to the character of gain or loss on the disposition of dealer property transferred to or from a passthrough entity. Gain or loss on the disposition of property by a partnership that is dealer property in the hands of a contributing partner immediately before contribution remains ordinary in nature for a period of five years beginning on the date of contribution. The same is true with respect to dealer property in the hands of a partnership that is distributed to one or more of its partners. With respect to S corporations, a sale by the S corporation of property that was dealer property in the hands of the contributing shareholder immediately before contribution results in ordinary gain or loss, with no applicable five-year limit on the duration to which the character is frozen. As a result, taxpayers should be mindful of whether property contributed to a passthrough entity or distributed from a passthrough entity constitutes dealer property with respect to the contributing partner or shareholder or the distributing partnership or corporation.

ENDNOTES

1 *F. Thompson*, CA-5, 63-2 ustc ¶9676, 332 F2d 122.

2 *See* Code Sec. 702(b); Reg. §1.702-1(b); *W.E. Campbell*, CA-5, 87-1 ustc ¶9253, 813 F2d 694; *Pacific Securities*, 63 TCM 2060, Dec. 48,003(M), TC Memo. 1992-90.

3 Reg. §1.1366-1(b)(1).

4 The Code Sec. 751(d) definition of "inventory" is modified for purposes of its application to Code Sec. 724(b) to exclude not only capital assets but also property described in Code Sec. 1231, determined without regard to the one-year and a day holding requirement. Code Sec. 724(d)(2).

5 For purposes of Code Sec. 735, Code Sec. 735(c)(1) modifies the Code Sec. 751(d) definition of "inventory" to exclude both capital assets and any property described in Code Sec. 1231 (determined without regard to the required one-year and a day holding period).

6 Code Sec. 735(a)(2).

7 Code Sec. 735(a)(1).