CURRENT TAX ISSUES AFFECTING REAL ESTATE

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Proposed Regulations under Sections 707 and 752

On January 30, 2014, the IRS issued a Notice of Proposed Rulemaking[1] including Proposed Regulations under Internal Revenue Code ("IRC") sections 707 (disguised sales) and 752 (allocations of liabilities) of the.[2] The Proposed Regulations are primarily focused on limiting the use of debt financed distributions by taxpayers to avoid the impact of the disguised sale rules of section 707(a)(2)(B). The proposed section regulations have much broader impact, however and, if adopted in the form proposed, will impact large numbers of transactions.

Background

To understand the reason for the proposal, it is helpful to set forth the circumstances under which debt financed distributions are employed. They are a common feature of UPREIT[3] transactions. An UPREIT structure is one wherein a real estate investment trust ("REIT") holds all of its real estate assets through an operating partnership (an "OP") that the REIT controls. An owner of real estate with, for example, a gross fair market value of $20 million and debt of $5 million may transfer his real estate to an OP in exchange for $15 million of "Units" (i.e. partnership interests) in the OP. Such a transaction is tax deferred under section 721.[4] A property owner, however, will often want to receive a portion (often a large portion) of

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1 Notice of Proposed Rulemaking, 79 Fed. Reg. 4826 (Jan. 30, 2014) (hereinafter the "NOPR"), published in Internal Revenue Bulletin 2014-8.

2 Unless otherwise stated, all section citations are to the Internal Revenue Code of 1986, as amended, or the regulations thereunder.

3 Which stands for "umbrella partnership real estate investment trust."

4 In contrast, a transfer of real property to the REIT in exchange for stock in the REIT is generally not tax deferred due to limitations in section 351. In order for a transferor's transfer of real property directly to the REIT to be tax deferred, the transferor would need to control 80% of the vote and value of the REIT's stock after the transfer. See sections 351(a), 368(c). Section 721 imposes no control requirement for tax deferral with respect to transfers of property to a partnership (such as an OP).

the net value of his property in the form of cash. If the OP simply pays cash to the owner, the transaction will be taxable as a "disguised sale" under section 707(a)(2)(B).

To avoid gain, UPREIT transactions involving the payment of cash to the property owner are often structured by having the OP borrow funds (either by way of a mortgage on this or other OP-owned properties or by drawing down on its line of credit) and distributing these funds to the property owner. Such a distribution will be tax deferred only if the funds borrowed by the OP are allocable, under section 752, to the property owner. Since the property owner has only a miniscule percentage interest in the OP, nonrecourse debt will not ordinarily be allocable to the owner under the applicable section 752 regulations (discussed in more detail below). If, however, the distribution is funded with recourse debt, and if the property owner is the partner with the "economic risk of loss" for such debt, the debt will be allocable to the property owner[5] and the distribution will be tax deferred, as the property owner will not have received a cash distribution in excess of his basis in the OP.[6]

To accomplish this allocation of the debt, it is necessary for the property owner to guarantee the loan. Understandably, a property owner is not interested in making a guarantee that has material economic risk to him since he often could have borrowed funds on a nonrecourse basis without transferring ownership to the OP in the first place. To accommodate the property owner's desire for a guarantee with less economic risk, practitioners developed the concept of a "bottom guarantee." Go back to our example above in which the property owner transfers property with a net value of $15 million to the OP in exchange for Units. Assume that the objective of the owner is to receive $10 million in cash. The OP can refinance the mortgage of the property contributed increasing the amount of the mortgage from $5 million to $15 million and generate $10 million of net refinancing proceeds which it can distribute to the property owner. The owner can guarantee the bottom $10 million of the mortgage. Under a bottom guarantee, the lender can only require a payment from the guarantor if the lender obtains less than $10 million on a foreclosure sale of the property. Thus, although the lender is lending 75 percent of the gross value of the property, the guarantee only guarantees debt equal to 50 percent of the gross value of the property. The guarantor's risk can be reduced further if the OP packages

[5] Reg. section 1.752-2(a).

[6] Section 731(a)(1).

the contributed property with other properties and borrows the $10 million against the group of properties. In that event, the bottom guarantee may only guarantee, for example, the bottom 10 or 20 percent of the loan, in which event the economic risk is almost nonexistent. In most if not all of these cases, the lender is indifferent as to whether or not the guarantee is given since the lender is relying solely on the assets of the partnership to secure the loan.

Relevant Statutory Provisions

Section 721(a) provides that recognition of gain does not occur upon the contribution of property by a partner to a partnership. Section 731(a)(1) provides for nonrecognition of gain on the distribution of property by a partnership to a partner.[7] However, section 707(a)(2)(B), enacted in 1984, provides that in the case of "disguised sale," the ordinary principles of sections 721 and 731 do not apply and the partner must recognize gain on the transaction. Distributions made to a partner in connection with of a contribution of property by the partner will generally be treated as a "disguised sale" if, when viewed together, they are "properly characterized as a sale or exchange of property."[8]

Existing Regulations

The existing regulations under section 707 provide for a "facts and circumstances" analysis to determine whether a contribution to a partnership and a distribution from the partnership together constitute a disguised sale.[9] The regulations provide a presumption that a distribution made by a partnership within two years of a property contribution is a disguised sale.[10] The regulations provide exceptions to disguised sale treatment. In this context the most relevant exception is that a distribution is not considered part of a disguised sale if (i) the cash distributed to the contributing partner is traceable to the cash borrowed; (ii) the partnership distributes the cash within 90 days of borrowing; and (iii) the debt is properly

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7 Except in the case of cash or marketable securities distributed in excess of the taxpayer's basis in the partnership. See section 731(a)(1), (c).

8 Section 707(a)(2)(B).

9 Reg. section 1.707-3(b).

10 Reg. section 1.707-3(c).

allocable to the partner receiving the cash under section 752 and the regulations thereunder.[11] The theory of this regulation is the same theory that applies to the receipt of loan proceeds by the owner of real estate. A borrowing is generally not treated as a sale of the property because the taxpayer is obligated to repay the debt.

The question then becomes, "How do the current regulations enable a bottom guarantee to be effective?" For those of you interested in ancient history, when we started practicing in the 1970's, Reg. section 1.752-1(e), which was adopted in 1956, set forth the rules on allocations of debt among partners. It consisted of one paragraph of three sentences, as follows:

> Partner's share of partnership liabilities. A partner's share of partnership liabilities shall be determined in accordance with his ratio for sharing losses under the partnership agreement. In the case of a limited partnership, a limited partner's share of partnership liabilities shall not exceed the difference between his actual contribution credited to him by the partnership and the total contribution which he is obligated to make under the limited partnership agreement. However, where none of the partners have any personal liability with respect to a partnership liability (as in the case of a mortgage on real estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage), then all partners, including limited partners, shall be considered as sharing such liability under section 752(c) in the same proportion as they share the profits.

The regulations distinguished between recourse and nonrecourse debt and set forth different rules for each category, concluding reasonably in most cases that recourse debt should be shared in accordance with loss allocations and nonrecourse debt should be shared in accordance with profit allocations. Over time, as partnership transactions became more complicated, Treasury and the IRS felt the need to elaborate on many of these issues. In addition, the 1984 Tax Reform Act overruled[12] the Court of Claims decision in Raphan v. United States,[13] which held that a partner who guaranteed partnership debt was not personally liable for

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11 Reg. section 1.707-5(b), (f), ex. (10).

12 See section 8.A of the NOPR.

13 3 Ct. Cl. 457 (1983), aff'd in part, rev'd in part 759 F.2d 879 (Fed. Cir. 1985) (the Federal Circuit reversed with respect to the issue at hand).

such debt. The Act directed Treasury to prescribe regulations relating to the treatment of guarantees.[14]

In 1991, new regulations under section 752 were promulgated,[15] and unlike the earlier version, cannot be printed due to space limitations. The important point to keep in mind is that the regulations define nonrecourse debt as debt for which no partner nor person related to a partner has economic risk of loss ("EROL").[16] If the debt is nonrecourse to the partnership, but a partner (or person related to that partner) bears any EROL with respect to such debt, then such debt or the portion thereof was treated as partner nonrecourse debt.[17] Partner nonrecourse debt was required to be allocated to the partner who bore the EROL.[18] A partner would have EROL if such partner (or a person related to that partner) either made a loan to the partnership or guaranteed a third party loan and did not have a right of reimbursement from other partners.[19]

More significantly, the regulations adopted a simple if unreasonable explanation of how to determine whether or not a partner had an EROL. The regulations provided that, for this purpose, it is assumed that all assets of the partnership, including cash, are disposed of for zero consideration.[20] The only exception from the zero consideration assumption is for assets that secure debt for which the lender has no other recourse; such assets are deemed disposed of for the amount of the debt they secure.[21] If, under these assumed circumstances, the partnership lenders have any rights to collect any sums from any of the partners or related persons, such partners have EROL for the amount they would be obligated to pay. The amount of debt would then be allocable to such partner.[22]

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14 See section 8.A of the NOPR.

15 Adopted by T.D. 8380 (Dec. 23, 1991).

16 Reg. section 1.752-1(a)(2).

17 Reg. section 1.704-2(b)(4).

18 Reg. section 1.752-2(b).

19 Reg. section 1.704-2(b)(4).

20 Reg. section 1.752-2(b)(1).

21 Reg. section 1.752-2(b)(1)(ii) and (iii).

22 Reg. section 1.752-2(b)(5).

The ability to utilize a bottom guarantee to avoid disguised sale treatment, thus, is a direct result of this simplistic choice in the regulation. If all of the assets of a partnership are assumed to be worthless, any partner guarantee, no matter how unlikely to be enforced, is considered to be a real liability. Notably, in addition to the assumption that the partnership can pay none of its liabilities, the regulations assume that all partners and related persons who are obligated on partnership debts can perform those obligations, irrespective of their net worth, absent facts that indicate a plan to circumvent the obligations.[23]

Prior IRS Attempts to Limit the Perceived Abusive Use of Guarantees

Prior to the issuance of the proposed regulations in January, the government had taken two steps to limit debt financed distributions claimed to be exempt from the disguised sale rules. First, Treasury issued regulations on guarantees by disregarded entities. These regulations were meant to deal with the situation where a partner in a partnership held its interest through a wholly owned LLC that was disregarded for income tax purposes. If a disregarded entity with no assets other than its partnership interest guarantees partnership debt, in theory funds could be distributed tax free under the debt financed distribution rules to the disregarded entity and then to the partner with no economic risk. To stop that abuse, the IRS issued regulations in 2006 providing that disregarded entities would only be treated as having an EROL in an amount equal to their net worth, which regulation provides elaborate rules setting forth the timing and methodology of computing the net worth of disregarded entities.[24] Nevertheless, this regulation is so easy to work around (by creating entities that are not disregarded) that it is unlikely this regulation had any material impact.

More significantly, the IRS successfully litigated Canal Corp.,[25] a large case using the anti-abuse exception to the rule that presumes that guarantors (or indemnitors) will be able to perform their obligations mentioned earlier. In Canal Corp., taxpayer's subsidiary was a partner in a joint venture (the "JV"),[26] which made a debt financed distribution to the subsidiary. Prior

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[23] Reg. section 1.752-2(b)(6).

[24] Reg. section 1.752-2(k), adopted by T.D. 9289 (Oct. 10, 2006).

[25] Canal Corp. v. Commissioner, 135 T.C. 199 (2010). See, similarly, CCA 201324013.

[26] The joint venture was a partnership for income tax purposes.

to the distribution, the subsidiary gave an indemnity to the other partner in the JV, who had guaranteed the JV's debt. The subsidiary's only substantial asset (other than the partnership interest) was a promissory note from its parent corporation, the ultimate recipient of the distributed funds.[27] The net worth of the subsidiary (excluding its interest in the JV) was approximately 21 percent of the amount of the indemnity, an amount that the taxpayer's tax advisors considered sufficient to avoid being disregarded. However, the Tax Court concluded that the indemnity could be disregarded on several grounds, most notably that there was no requirement that the subsidiary maintain any net worth (it could have canceled or distributed the note to its parent).

Impact of Proposed Regulations on Characterization of Debt

The January 2014 proposed regulations reflect in many ways an almost complete reversal of the approach taken in the current regulations. In general, the proposed regulations revert to the view of the original 1956 regulations that partnership debts are paid out of partnership profits and that profit allocations are the most relevant criteria for determining how to allocate partnership liabilities.

More significantly, the proposed regulations largely eliminate the use of guarantees by imposing requirements that will be impossible to meet even in those cases where a lender insists that partnership debt be guaranteed. A partner or related person will be treated as having an obligation to pay a partnership liability only if it satisfies the following (among other) requirements:[28]

(1) The partner must be required to maintain a commercially reasonable net worth throughout the term of the payment obligation or be subject to commercially reasonable restrictions on transfers of assets for inadequate consideration;[29]

(2) The partner or related person must be required periodically to provide commercially reasonable documentation of its net worth;[30]

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27 The subsidiary also owned a corporate jet.

28 See generally Prop. Reg. section 1.752-3(b)(3)(ii).

29 Prop. Reg. section 1.752-3(b)(3)(ii)(A).

30 Prop. Reg. section 1.752-3(b)(3)(ii)(B).

(3) The partner's payment obligation does not end before the term of the partnership liability[31]

(4) The partnership or some other party may not be required to hold liquid assets in excess of its reasonable needs[32]

(5) The partner receives arm's length consideration for entering into the guarantee[33]

(6) The partner's obligation may not be subject to reimbursement or indemnification by another party, whether or not a partner or related person, even if the obligation of the other party is insufficient to cause such debt to be allocable to such other partner.[34]

In practice, these requirements will result in disregarding virtually all guarantees, even those undertaken for commercial purposes. Requirement (2) that the guarantee obligation remain in place for the entire term of a loan is more restrictive than most guarantees which burn off when the debtor satisfies certain economic criteria (e.g. completion of construction, payment of rent by tenant, etc.). Requirement (4) is generally considered problematic. Guarantee fees are rarely paid and it is not clear whether the partnership interest obtained by a developer for, among other things, guaranteeing a loan would satisfy this requirement.

Requirement (5) is designed to eliminate bottom guarantees but does so in a way that eliminates any horizontal slice guarantee other than the top slice. As an example, the proposed regulations provide that if one partner, A, guarantees $300 of a $1,000 partnership debt and another partner, C, agrees to indemnify A for $50 if A pays on its guarantee, C is considered to have the economic risk of loss on $50 but A is considered not to have any economic risk of loss and the remaining $950 of debt is considered nonrecourse debt for debt allocation purposes.[35]

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31 Prop. Reg. section 1.752-3(b)(3)(ii)(C).

32 Prop. Reg. section 1.752-3(b)(3)(ii)(D).

33 Prop. Reg. section 1.752-3(b)(3)(ii)(E).

34 Prop. Reg. section 1.752-3(b)(3)(ii)(G).

35 Prop. Reg. section 1.752-2(f), ex. (11).

Overall it is rare that a guarantee in a normal commercial real estate transaction will satisfy these requirements and be treated as creating EROL for purposes of the proposed section 752 regulations. Consequently, almost all third party real estate mortgages would be treated as nonrecourse debt regardless of the possibility that a portion of that debt may under various circumstances be borne by one or more of the partners or the likelihood of that occurring.

Effect of Proposed Regulations on Allocations of Nonrecourse Debt

In addition to causing most real estate debt to be characterized as nonrecourse, the proposed regulations would appear to change substantially how partnerships allocate such nonrecourse debt among its partners. We used the phrase "appear to" because, frankly, we do not see how tax preparers will be able to comply with the proposed allocation provisions.

To appreciate the issue, it is helpful to review the existing section 752 regulations governing allocations of nonrecourse debt.[36] As a general matter, the regulations reflect the common understanding that allocations of pure nonrecourse debt (i.e. debt for which no partner nor related person has EROL) are basically arbitrary as only the third party lender bears any economic risk. The regulations are largely designed to cause partnerships to coordinate debt allocations with corresponding allocations of income and deductions. The regulations do this by setting up three tiers of allocations. First, nonrecourse debt is allocated to correlate to future allocations of partnership minimum gain (i.e. gain attributable to the excess of the nonrecourse debt over the tax basis).[37] For example, a partnership agreement between a developer who contributes 1 percent of the capital and a money partner who contributes 99 percent of the capital may provide that, once the capital accounts of the partners are reduced to zero by means of losses or distributions, further nonrecourse deductions will be allocated 50 percent to each (their ultimate profit percentages once certain IRR hurdles are satisfied). Since, in this case, the deductions are allocable 50/50 each partner will be allocated 50 percent of the nonrecourse debt. A similar result would exist if, under the partnership agreement, excess loan proceeds were distributed 50 percent to each partner.

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36 Reg. section 1.752-3.

37 Reg. section 1.752-3(a)(1).

The second tier of allocations is an amount equal to the gain (generally referred to partner minimum gain) that would be allocated to a partner by reason of either (i) a section 704(c) allocation with respect to property contributed by the partner to the partnership; or (ii) a so-called reverse 704(c) allocation with respect to a revaluation of partnership property.[38] Since the book value of partnership property upon contribution or certain other events is increased to its agreed value, such property does not have *partnership* minimum gain (i.e. the book value is not less than the amount of the mortgage). To avoid triggering gain to the partners who will have section 704 allocations, the second tier regulation allocates them sufficient debt.

The third tier allocations is in accordance with the partnership's allocations of profits (or by certain other methods).[39] This regulation, however, provides a partnership with substantial flexibility in determining how to allocate this third tier. In particular, so long as the allocation of profits for purposes of purposes of allocating nonrecourse liabilities are consistent with an allocation of "some other significant item of partnership income or gain," the agreement's allocation will be respected. In practice, partners are generally considered to have wide latitude in determining the allocation of profits for purposes of allocating nonrecourse liabilities under the third tier. Thus, in the example we gave above, the partnership could allocate the third tier debt 99/1, 50/50, and in many cases somewhere in between those percentages.[40] As an alternative, excess nonrecourse liabilities may also be allocated among the partners in accordance with the manner "in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated."[41] As an additional alternative, since 2000, the Regulations have specified that a partnership may 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 this nonrecourse

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38 Reg. section 1.752-3(a)(2).

39 Reg. section 1.752-3(a)(3).

40 Although Reg. section 1.752-3 does not specify that an allocation of excess nonrecourse liabilities in the range between allocations of "significant items" is permissible, the regulation on allocation of nonrecourse *deductions* does. Reg. section 1.704-2(m), ex. (1)(ii), specifically allowed allocations of nonrecourse deductions in any ratio between 90/10 and 50/50 where there were allocations of significant items of tax at 90/10 and 50/50 ratios.

41 If a partnership uses this method of liability allocation for purposes of section 752, the method apparently would apply for disguised sale purposes as well.

liability was not already allocated to the partner under the second tier).[42] This change was meant to avoid gain recognition to a contributing partner as the amount of section 704(c) gain (and correspondingly the amount of second tier debt) burns off due to depreciation deductions with respect to the contributed property taken after the contribution.[43]

The proposed regulations would eliminate the provisions of the third tier allocation, which provide flexibility in determining the share of profits and deductions. Although the regulation as amended would still provide that the third tier is allocated in accordance with profits (or in accordance with 704(c) or reverse 704(c) gain not allocated under the second tier), the elimination of discretion is likely to create substantial confusion in all cases where profits are not done on a simple percentage basis. The proposed regulations eliminate a partnership's ability to allocate excess nonrecourse debt in accordance with a "significant item" of tax, or in a manner that "in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated."

Instead, the proposed regulations substitute in a method whereby excess nonrecourse deductions are allocated in accordance with profits under a liquidation value approach.[44] Under such liquidation value approach, the profits are periodically tested based on assumptions of how distributions would be made if the partnership were liquidated on the testing dates (i.e. the dates of formation and the dates when partnership book revaluations could occur even if they are not made). This relief provision will not help most partnerships that do not regularly have revaluation events.

In general, most accountants preparing partnership tax returns do not spend a great deal of time parsing the terms of the partnership agreement or the existing regulations. Rather they take a practical approach and report debt allocations in accordance with a simple overriding principle; any partner with a negative tax capital account must be allocated sufficient partnership debt to avoid gain recognition. Under the existing regulations, most accountants and

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42 Adopted by T.D. 8906 (Oct. 31, 2014).

43 This method of allocation of nonrecourse debt is not available when allocating debt for purposes of the disguised sale rules under section 707.

44 Prop. Reg. section 1.752-3(a)(3).

lawyers could feel comfortable that, one way or another, the debt allocation made is permissible. Under the proposed regulations, it will be far harder to do so.

Effective Dates

In general the proposed regulations are effective with respect to debt incurred after the regulations become final.[45] To avoid triggering gain attributable to a change in the character of debt incurred prior to the effective date, the regulations proposed with respect to EROL and guarantees set forth a seven year transition period.[46] There is no transition period for the proposed disguised sale regulations or the proposed changes to the allocation of excess nonrecourse liabilities.

Recent IRS Informal Announcements

In recent weeks word has come out that the IRS is looking for ways to limit the impact of the proposed regulations, for now, to disguised sales under section 707 rather than apply the proposed regulations generally under section 752.

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45 Prop. Reg. sections 1.707-9(a)(1), 1.752-2(*l*)(1), 1.752-3(d).

46 Prop. Reg. section 1.752-2(*l*)(2)(i).