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Partnership Planning & Pitfalls

Panelists

Moderator:
Terence Cuff, Of Counsel, Loeb & Loeb LLP

Panelists:
Adam Cohen, SVP-Tax, iStar
Cameron Cosby, Partner, Hogan Lovells
Sanford Presant, Chairman-Real Estate Fund Practice Group, Greenberg Traurig, LLP
Andrea Whiteway, Principal, EY

The “New” New Proposed, Temporary and Final Regulations

Final Regulations

- Section 707 – reimbursement of preformation expenditures exception
- Section 752
  - For purposes of allocating excess nonrecourse liabilities under Treas. Reg. § 1.752-3, none of the section 704(c) fill-up method, the significant item method nor the alternative method apply for purposes of determining a partner's share of a partnership liability for section 707 disguised sale purposes
- These regulations are effective on October 5, 2016

Temporary Regulations under Section 707

- Treat all partnership liabilities, whether recourse or nonrecourse, as nonrecourse liabilities solely for purposes of section 707

- Partner required to apply the same percentage used to determine the partner's share of excess nonrecourse liabilities under Treas. Reg. § 1.752-3(a)(3) (with certain limitations) in determining partner's liability share for disguised sale purposes

- In determining partner's share of a partnership liability for disguised sale purposes do not include any amount of the liability for which another partner bears economic risk of loss under Treas. Reg. § 1.752-2.

- Effective Date: Apply to any transaction with respect to which **all** transfers occur on or after January 3, 2017.

Temporary Regulations under Section 752

- Bottom dollar payment obligation" will not be respected
- Definition includes (subject to exceptions):
  - (1) any payment obligation other than one in which the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that
    - (A) any amount of the partnership liability is not otherwise satisfied in the case of an obligation that is a guarantee or other similar arrangement, or
    - B) any amount of the indemnitee's or benefited party's payment obligation is satisfied in the case of an obligation which is an indemnity or similar arrangement; and

Temporary Regulations under Section 752
(cont'd)

- (2) an arrangement with respect to a partnership liability that uses tiered partnerships, intermediaries, senior and subordinate liabilities, or similar arrangements to convert what would otherwise be a single liability into multiple liabilities if, based on the facts and circumstances, the liabilities were incurred
  - A) pursuant to a common plan, as part of a single transaction or arrangement, or as part of a series of related transactions or arrangements, and
  - (B) with a principal purpose of avoiding having at least one of such liabilities or payment obligations with respect to such liabilities being treated as a bottom dollar payment obligation

Temporary Regulations under Section 752 (cont'd)

- Any payment obligation under Treas. Reg. § 1.752-2 may be a bottom dollar payment obligation if it meets the requirements, including:
  - obligation to make a capital contribution
  - obligation to restore a deficit capital account upon liquidation of the partnership
- Exception to bottom dollar payment obligation treatment if, taking into account the indemnity, reimbursement agreement, or similar arrangement, the partner or related person is liable for at least 90 percent of the initial payment obligation

Temporary Regulations under Section 752
(cont'd)

- Certain payment obligations excepted from being treated as bottom dollar payment obligations:
  - obligations with joint and several liability;
  - as long as a partner or related person is or would be liable for the full amount of a payment obligation, such obligation is not a bottom dollar payment obligation merely because a maximum amount is placed on the partner's or related person's obligation;
  - vertical slice of a partnership liability

Temporary Regulations under Section 752
(cont'd)

- Anti-abuse rule in § 1.752-2T(j)(2)
  - Commissioner may apply to ensure that if a partner actually bears EROL for a partnership liability, partners may not agree among themselves to create a bottom dollar payment obligation so that the liability will be treated as nonrecourse.

- Disclosure required of all bottom dollar payment obligations with respect to a partnership liability on a completed Form 8275, Disclosure Statement, attached to the partnership return for the taxable year in which the bottom dollar payment obligation is undertaken or modified

Temporary Regulations under Section 752
(cont'd)

- Effective Date: Applies to liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken with respect to a partnership liability on or after October 5, 2016, other than liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken pursuant to a written binding contract in effect prior to that date.

- Partnerships may apply all the provisions to all liabilities as of the beginning of the first taxable year of the partnership ending on or after October 5, 2016

Temporary Regulations under Section 752: Transition Rule

- Seven-year transition period
  - During this period, if a partner (“Transition Partner”) has a share of recourse liabilities under current rules, partnership may choose not to apply new rules to an amount of partnership liabilities equal to the excess of the Transition Partner’s share of recourse liabilities over the Transition Partner’s adjusted basis in the partnership interest
  - Amount of liabilities to which transition rule applies is reduced to the extent built-in gain attributable to Transition Partner’s negative tax basis capital account is recognized
  - If Transition Partner is a partnership, S corporation or disregarded entity, 50 percent or more change in ownership of Transition Partner will terminate the transition period

Proposed Regulations under Section 704

- A partner in no event will be considered obligated to restore the deficit balance in his capital account to the partnership to the extent such partner's obligation is a bottom dollar payment obligation that is not recognized under Treas. Reg. § 1.752–2(b)(3) or is not legally enforceable, or the facts and circumstances otherwise indicate a plan to circumvent or avoid such obligation.

- To the extent a partner is not considered obligated to restore the deficit balance in the partner's capital account to the partnership, the obligation is disregarded and Section 704(b) and Section 752 are applied as if the obligation did not exist.

Proposed Regulations under Section 704
(cont'd)

- Factors specific to DROs that indicate a plan to circumvent or avoid an obligation:
  - (1) The partner is not subject to commercially reasonable provisions for enforcement and collection of the obligation;
  - (2) the partner is not required to provide (either at the time the obligation is made or periodically) commercially reasonable documentation regarding the partner's financial condition to the partnership;

Proposed Regulations under Section 704 (cont'd)

- (3) the obligation ends or could, by its terms, be terminated before the liquidation of the partner's interest in the partnership or when the partner's capital account as provided in § 1.704–1(b)(2)(iv) is negative; and
- (4) the terms of the obligation are not provided to all the partners in the partnership in a timely manner.

- Effective Date: DROs are subject to the bottom dollar payment obligation rules in the 752 Temporary Regulations effective immediately, **but** the 704(b) proposed regulations concerning DROs will be effective when published as final regulations

Proposed Regulations under Section 752

- List of factors added to an anti-abuse rule in Treas. Reg. § 1.752–2(j)
- Factors are weighed to determine whether a payment obligation is respected.
- Factors are nonexclusive list
- Presence or absence of any particular factor, in itself, is not necessarily indicative of whether or not payment obligation is recognized

Proposed Regulations under Section 752
(cont'd)

- Factors.
  - (A) The partner or related person is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment, including, for example, restrictions on transfers for inadequate consideration or distributions by the partner or related person to equity owners in the partner or related person.
  - (B) The partner or related person is not required to provide (either at the time the payment obligation is made or periodically) commercially reasonable documentation regarding the partner's or related person's financial condition to the benefited party.

Proposed Regulations under Section 752
(cont'd)

- (C) Term of obligation ends prior to term of partnership liability, or partner or related person has a right to terminate its obligation, if purpose of limiting duration of obligation is to terminate such obligation prior to occurrence of event that increases risk of economic loss
  - For example, termination prior to the due date of a balloon payment or a right to terminate that can be exercised because the value of loan collateral decreases.

Proposed Regulations under Section 752
(cont'd)

- Factor typically not present if termination occurs by reason of event that decreases risk of economic loss (e.g. upon the completion of a building construction project, upon the leasing of a building, or when certain income and asset coverage ratios are satisfied for a specified number of quarters).

- (D) There exists a plan or arrangement in which obligor or related person holds money or other liquid assets in an amount that exceeds the reasonable foreseeable needs of such obligor.

Proposed Regulations under Section 752
(cont'd)

- (E) Obligation does not permit creditor to promptly pursue payment following a payment default on the partnership liability, or other arrangements with respect to the liability or obligation otherwise indicate a plan to delay collection.

- (F) In the case of a guarantee or similar arrangement, terms of the partnership liability would be substantially the same had the partner or related person not guaranteed the liability.

- (G) Creditor did not receive executed documents before, or within a commercially reasonable period of time after, the creation of the obligation.

Proposed Regulations under Section 752
(cont'd)

- Propose to remove § 1.752–2(k) (DRE Net Value Rule) and instead create a new presumption under the anti-abuse rule in § 1.752–2(j).
- Under the presumption, evidence of a plan to circumvent or avoid an obligation is deemed to exist if the facts and circumstances indicate that there is **not a reasonable expectation that the payment obligor will have the ability to make the required payments** if the payment obligation becomes due and payable.
- Effective Date: When Finalized

Examples Illustrating New Regulations

Example #1: Contribution of Property to OP

Example #2: Bottom Guarantee Existing Before 10/5/2016

Example #3: Reimbursement of Preformation Expenditures

Example #1: Contribution of Property to OP

Background

- Property to be contributed to the OP is owned by Contributing Partnership
- Property is office building generating rental income:

Gross FMV	$100
Mortgage Debt	$70
Equity Value	$30
Adjusted Tax Basis	$40
Built-in Gain	$60
Negative Capital Accounts (Minimum Gain)	($30)

Example #1: Contribution of Property to OP

Background (cont'd)

- Mortgage debt
  - incurred more than 2 years ago
  - secured by the property
  - not recourse to Contributing Partnership partners
  - is assumable, but OP wants to refinance with its credit facility at lower interest rate

Example #1: Contribution of Property to OP

Background (cont'd)

- OP's credit facility
  - nonrecourse debt (i.e., the lender has agreed that the loan is not recourse against any of the partners, including the general partner, and the loan is not guaranteed by the REIT)
  - not secured by OP's properties

Example #1: Contribution of Property to OP

Background (cont'd)

- If OP assumes mortgage debt, issues $30 of OP Units to Contributing Partnership and repays mortgage debt,
  - Contributing Partnership could recognize $30 of gain at closing (a deemed cash distribution of $70 in excess of the tax basis of $40, equal to the negative capital accounts of Contributing Partnership partners).

Example #1: Contribution of Property to OP

Option #1: OP Uses "Additional Method" on Nonrecourse Debt

- For a period of time, the OP agrees:
  - To maintain at least $30 of nonrecourse debt (could be the credit facility).
  - To allocate that nonrecourse debt to Contributing Partnership using the "additional method" in Reg. § 1.752-3(a)(3) (i.e., allocate debt to Contributing Partnership up to its built-in gain on section 704(c) property).

Example #1: Contribution of Property to OP

Option #1: OP Uses "Additional Method" on Nonrecourse Debt (cont'd)

- At time of contribution, protects Contributing Partnership from recognizing the built-in gain
- Over time, as the built-in gain "burns off" as a result of the required allocations of tax depreciation away from Contributing Partnership under section 704(c), Contributing Partnership could recognize some built-in gain.

Example #1: Contribution of Property to OP

Option #2: Contributing Partnership Guarantees Nonrecourse Debt

- Contributing Partnership guarantees (the "Partner Guarantee") nonrecourse debt of the OP up to $30.
- Under new temporary regulations § 1.752-2T(3), the Partner Guarantee must not be a "bottom dollar payment obligation."
- Partner Guarantee would be a bottom dollar payment obligation if Contributing Partnership (or a related person) is not liable up to the full amount of Contributing Partnership's (or related person's) payment obligation under Partner Guarantee if, and to the extent that, any amount of the OP debt is not otherwise satisfied.

Example #1: Contribution of Property to OP

Option #2: Contributing Partnership Guarantees Nonrecourse Debt (Cont'd)

- Partner Guarantee can be limited to a dollar amount (in this example, $30), can be limited to a fixed percentage of every dollar of guaranteed debt, or can be a joint and several obligation.
- A guarantee of this type is likely not an attractive option for Contributing Partnership.

Example #1: Contribution of Property to OP

Option #2: Contributing Partnership Guarantees Nonrecourse Debt (cont'd)

- Under the new proposed regulations (§ 1.752-2(j)(3)), ask whether there is a plan to circumvent or avoid the Partner Guarantee, taking into account the following non-exclusive list of factors:
  - Is Contributing Partnership subject to commercially reasonable contractual restrictions that protect the likelihood of payment, including restrictions on transfers for inadequate consideration or distributions?
  - Is Contributing Partnership required to provide (up front or periodically) commercially reasonable documentation regarding Contributing Partnership's financial condition?

Example #1: Contribution of Property to OP

Option #2: Contributing Partnership Guarantees Nonrecourse Debt (cont'd)

- Does the Partner Guarantee end prior to the term of the guaranteed debt, or does Contributing Partnership have the right to terminate the Partner Guarantee?
- Does the OP directly or indirectly hold money or other liquid assets in an amount that exceeds the reasonable foreseeable needs of the OP?
- Does the Partner Guarantee permit the OP lender to promptly pursue payment following a payment default on the guaranteed debt?

Example #1: Contribution of Property to OP

Option #2: Contributing Partnership Guarantees Nonrecourse Debt (cont'd)

- Would the terms of the guaranteed debt be substantially the same had Contributing Partnership not agreed to provide the Partner Guarantee?
- Did the OP lender receive the Partner Guarantee from Contributing Partnership before, or within a commercially reasonable period of time after, the creation of the guaranteed debt?

Example #1: Contribution of Property to OP

Option #2: Contributing Partnership Guarantees Nonrecourse Debt (cont'd)

- Under proposed regulations, also must ask whether there is a reasonable expectation that Contributing Partnership will have the ability to make the required payments under the Partner Guarantee if the Partner Guarantee becomes due and payable.

- Proposed regulations effective when finalized - apply to liabilities incurred or assumed by a partnership and to payment obligations imposed or undertaken with respect to a partnership liability on or after the date of the final regulations.

Example #1: Contribution of Property to OP

Option #3: Contributing Partnership Enters into DRO

- Contributing Partnership enters into a deficit restoration obligation (a "DRO") upon liquidation of OP (including a liquidation of Contributing Partnership's interest in OP) up to $30.
- Assuming there is adequate recourse debt available at the OP.
- Partnership Agreement meets the requirements of the Section 704(b) safe harbor, and Partnership Agreement provides for allocation of first dollars of loss to create the deficit book capital account.
- DRO must not be a "bottom dollar payment obligation"

Example #1: Contribution of Property to OP

Option #3: Contributing Partnership Enters into DRO (cont'd)

- Under new proposed regulations (§ 1.704-1(b)(2)(ii)(c)(4), a DRO is disregarded to the extent is not legally enforceable, or the facts and circumstances otherwise indicate a plan to circumvent or avoid the DRO, based on the following non-exclusive list of factors:
  - Contributing Partnership is not subject to commercially reasonable provisions for enforcement and collection of the DRO.
  - Contributing Partnership is not required to provide (either up front or periodically) commercially reasonable documentation regarding its financial condition to OP.

Example #1: Contribution of Property to OP

Option #3: Contributing Partnership Enters into DRO (cont'd)

- DRO ends or could, by its terms, be terminated before liquidation of Contributing Partnership's interest in OP or when Contributing Partnership's capital account is negative.
- Terms of DRO are not provided to all OP partners in a timely manner.

- The proposed regulations apply on or after the date they are finalized

- Option #3 may be more attractive than Option #2, but it may not be clear whether all of the requirements in the proposed regulations can be satisfied when the regulations become effective.

Example #2: Bottom Guarantee Existing Before 10/5/2016

Background

- Before October 5, 2016, Partner A entered into a “bottom guarantee” with respect to a loan incurred by OP (the “Guaranteed Loan”).
- Bottom guarantee is treated as a “bottom dollar payment obligation” under the new temporary regulations which became effective on October 5, 2016.
- Guaranteed Loan is maturing or OP wants to repay it.
- OP intends to incur new nonrecourse debt secured by the same property.

Example #2: Bottom Guarantee Existing Before 10/5/2016

Background (cont'd)

- OP willing to cooperate with Partner A to prevent Partner A from recognizing income as a result of Guaranteed Loan payoff.
- Partner A has the following characteristics as of October 4, 2016:

Bottom Guarantee	$30
Share of Nonrecourse Liabilities	$10
Adjusted Tax Basis	$10

Example #2: Bottom Guarantee Existing Before 10/5/2016

Option #1: Partner A Enters into New Bottom Guarantee of Nonrecourse Debt

- If OP chooses to apply transition rules, Partner A can enter into a new "bottom guarantee" that is not subject to new regulations, but only to the extent of the "Grandfathered Amount."

- Grandfathered Amount is excess of Partner A's old "bottom guarantee" over Partner A's adjusted basis in its interest in the OP. Grandfathered Amount is measured on October 4, 2016 and is reduced (not below zero), but never increased by:

Example #2: Bottom Guarantee Existing Before 10/5/2016

Option #1: Partner A Enters into New Bottom Guarantee of Nonrecourse Debt (cont'd)

- Upon sale of the contributed property, any section 704(c) gain; and
- Certain reductions in the amount of liabilities allocated to Partner A under the transition rules.

- New bottom guarantee becomes subject to the new regulations on October 4, 2023 (7 years after the new temporary regulations became effective). Thus, this option is only available for about 7 years even though the new bottom guarantee obligation may last beyond 7 years.

Example #2: Bottom Guarantee Existing Before 10/5/2016

Option #1: Partner A Enters into New Bottom Guarantee of Nonrecourse Debt (cont'd)

- If (i) Partner A is a partnership, S corporation, qualified REIT subsidiary, qualified subchapter S subsidiary or disregarded entity and (ii) the direct or indirect ownership of Partner A changes by 50% or more after October 5, 2016,
  - Partner A ceases to qualify as a "Transition Partner" and will become subject to the new temporary regulations at that time.

Example #2: Bottom Guarantee Existing Before 10/5/2016

Option #1: Partner A Enters into New Bottom Guarantee of Nonrecourse Debt (cont'd)

- Grandfathered Amount is $20 ($30 bottom guarantee over $10 adjusted basis) because of the additional basis provided by the $10 share of nonrecourse liabilities.

- With a new bottom guarantee of only $20, if OP reduces its nonrecourse liabilities in the future, Partner A may trigger gain due to deemed cash distribution in excess of basis. Accordingly, Partner A is not completely protected from a gain recognition event under this option.

Example #2: Bottom Guarantee Existing Before 10/5/2016

Option #2: Partner A Guarantees Nonrecourse Debt

- Partner A could guarantee nonrecourse debt of OP.
- Guarantee must not be a “bottom dollar payment obligation”
- Under new proposed regulations, must determine that there is no plan to circumvent or avoid the guarantee and there must be reasonable expectation that Partner A will have the ability to make the required payments under the guarantee.
- A guarantee of this type is likely not an attractive option for Partner A.

Example #2: Bottom Guarantee Existing Before 10/5/2016

Option #3: Partner A Enters DRO

- Partner A enters into a DRO up to $30.
- Assuming there is adequate recourse debt available at the OP.
- Partnership Agreement meets the requirements of the Section 704(b) safe harbor, and Partnership Agreement provides for allocation of first dollars of loss to create the deficit book capital account.
- DRO must not be a “bottom dollar payment obligation”

Example #2: Bottom Guarantee Existing Before 10/5/2016

Option #3: Partner A Enters DRO (cont'd)

- Under new proposed regulations (§ 1.704-1(b)(2)(ii)(c)(4)), DRO must be legally enforceable, and the facts and circumstances must not otherwise indicate a plan to circumvent or avoid the DRO (based on the factors).

- This option (the "top" DRO) is more attractive than option #2 (the "top" guarantee"), but when the proposed regulations are finalized, it may not be clear whether the DRO will be respected.

Example #2: Bottom Guarantee Existing Before 10/5/2016

Option #4: OP Uses "Additional Method" on Nonrecourse Debt

- OP agrees, for a period of time:
  - To maintain at least $30 of nonrecourse debt.
  - To allocate that nonrecourse debt to Partner A using the "additional method" in § 1.752-3(a)(3) (i.e., allocate debt to Partner A up to its built-in gain on section 704(c) property).

Example #2: Bottom Guarantee Existing Before 10/5/2016

Option #4: OP Uses "Additional Method" on Nonrecourse Debt (cont'd)

- Because some of the built-in gain under section 704(c) attributable to Partner A will have "burned off" since the original property contribution, this option likely will not protect Partner A from recognizing some gain.
- Partner A will receive an allocation (based on its interest in profits) of other nonrecourse debt of the OP, but it is difficult to predict what this allocation will be each year because the OP could pay down its nonrecourse debt and Partner A's interest in profits could be reduced.

Example #3: Reimbursement of Preformation Expenditures

Background

- Assume the same facts as Example #1, except:
  - During the 2-year period preceding the contribution of the property to OP, Contributing Partnership incurred $20 of capital expenditures; and
  - Mortgage debt was incurred within the last 2 years and $20 of the mortgage debt was used to fund $20 of capital expenditures (with the remainder used to refinance debt that was incurred more than 2 years ago).

Example #3: Reimbursement of Preformation Expenditures

Background (cont'd)

- Contributing Partnership would like to receive as much cash as possible in connection with the property contribution without recognizing taxable income.
- OP would prefer to pay cash, rather than OP units, to Contributing Partnership.
- After property contribution, Contributing Partnership will own OP units representing 0.03% of OP profits.

Example #3: Reimbursement of Preformation Expenditures

Calculation

- Special rule for qualified liabilities (Treas. Reg. § 1.707-4(d)(4)) –
  - If capital expenditures were funded by the proceeds of a qualified liability that a partnership assumes or takes property subject to in connection with a transfer of property to the partnership by a partner, a transfer of money or other consideration by the partnership to the partner is not treated as made to reimburse the partner for such capital expenditures to the extent the transfer of money or other consideration by the partnership to the partner exceeds the partner's share of the qualified liability (as determined under § 1.707-5(a)(2), (3), and (4)).

Example #3: Reimbursement of Preformation Expenditures

Calculation (cont'd)

- Partner's share of liability (Treas. Reg. § 1.707-5T(a)(2)(i)) –
  - For purposes of the disguised sale rules, a partner's share of a liability of a partnership (whether a recourse liability or a nonrecourse liability) is determined by applying the same percentage used to determine the partner's share of the excess nonrecourse liability under § 1.752-3(a)(3) (as limited in its application to this sentence), but such share shall not exceed the partner's share of the partnership liability under section 752 and applicable regulations (as limited in the application of § 1.752-3(a)(3) to this sentence).

Example #3: Reimbursement of Preformation Expenditures

Calculation (cont'd)

- As amended, Treas. Reg. § 1.752-3(a)(3) provides that the significant method, alternative method, and additional method do not apply for purposes of Treas. Reg. § 1.707-5(a)(2). In other words, the partner's share of the liability must be allocated based on his share of profits, as determined based on the facts and circumstances.
- Contributing Partnership's share of mortgage debt used to fund the $20 of capital expenditures is $0.006 (0.03% x $20).
- Contributing Partnership can receive up to $0.006 in cash under exception for reimbursement of preformation expenditures without triggering gain on contribution.

Fractions Rule

Fractions Rule

- Exception (for “Qualified Organizations”) to UBTI from “Acquisition Indebtedness”.
- REITS care in case pension-held.

Proposed Regulations

The following issues are addressed in Proposed Regulations published on November 23, 2016.

1. Reasonable preferred return (current pay requirement eliminated).
2. Allocation of partner-specific items/disproportionate management fees (management fees can differ and be specially allocated).
3. Capital call default (no close scrutiny; allocations can match economic adjustments).

4. Unlikely loss exception -- Interaction with chargeback rule (will “more likely than not” be adopted?).
5. Staged closings (equalization permitted and no close scrutiny if conditions are not met).
6. Tiered partnership rule (clarified; no separate allocation of items required).
7. De minimis rule ($1 million exemption).

Still Open Fractions Rule

- No subordination of capital allowed in the waterfall,
  (no earn out subordination),
  (no planned future disproportionate funding).
- Staged closing interest still may not exceed 150% of AFR.
- Clawbacks still are not exempted.
- Substantial Economic Effect requirement – still no clarification that targeted allocations work if economics satisfy fractions rule.

Effective Date

- The Proposed Regulations will apply to taxable years ending on or after the date that the regulations are published as final regulations.
- Elective application earlier – a partnership and its partners may apply all rules contained in the Proposed Regulations for taxable years ending on or after November 23, 2016.

History

- 514(c)(9)(E) enacted 1988 (effective 6/1987)
- Notice 90-41 (90-1 CB 350)
- Final Regulations 5/11/1994
- ABA Report 1/19/2010
- Proposed Regulations 11/23/2016
- Jim Sowell Tax Notes Article (3/6/2017)
- Section 514(c)(9)(E) exemption form UBTI caused by Acquisition Indebtedness

Unless (i) all partners are Qualified Organizations or (2) qualified allocations (never varying) exist; property held by a partnership will not qualify for the real property exemption unless:

- the debt satisfies Section 514(c)(9) requirements, and
- An partnership allocations both:
  - Have substantial economic effect, and
  - Satisfy the “fractions rule”)

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Qualified Organizations Covered:

- **A "qualified organization" ("QO") is**:
  - Charitable organization described in section 170(b)(1)(A)(ii) and affiliated support organizations;
  - Pension trust described in section 401;
  - Title-holding company under section 501(c)(25);
  - Retirement income account under section 403(b)(9); or
  - Not charities (except educational institutions) and not foundations.

The Fractions Rule

- **The "fractions rule"**
  - The allocation of items to a QO cannot result in
    - a QO having a percentage share of overall partnership income for any taxable year
      - greater than
    - that QO's share of overall partnership loss for the taxable year in which such partner's share of loss is the smallest (i.e., the "fractions rule" percentage).

Reasonable Preferred Return Allocation Disregarded

- The Proposed Regulations would remove the requirement that cumulative income allocated with respect to a preferred interest cannot exceed cumulative preferred distributions made with respect to such interest by the due date of the partnership's tax return (not including extensions).
- Requires that, except for tax distributions, next distributions must first pay accrued preferred return (if not reversed by prior loss allocation).
- Do you need the reasonable preferred return exemption?

Partner-Specific Items and Divergent Management Fees

- The Proposed Regulations add management (and similar fees) to the current list of excluded partner-specific expenditures under existing section 1.514(c)-(2)(f), to the extent that these fees do not (in the aggregate for a taxable year) exceed 2% of the partner's aggregate committed capital (added to transfer expenses, foreign partners and administrative expenses, state/local taxes).
- The Proposed Regulations also include a request for comments concerning whether an imputed underpayment at the partnership level under section 6225 of the new partnership audit rules effective for 2018 should be included among the list of partner-specific expenditures.

Capital Call Default

- In the context of a capital default by a partner, a violation of the fractions rule could occur because of:

  (1) allocations matching the penalty "interest"/guaranteed payment earned by the partner contributing default capital or

  (2) allocations of loss to dilute defaulting partner.

Capital Call Default

- The Proposed Regulations state that if the partnership agreement provides for changes to allocations due to an unanticipated partner default on a capital contribution commitment or an unanticipated reduction in a partner's capital contribution commitment, and those changes in allocation are not inconsistent with the purpose of the fractions rule, then the changes will not be closely scrutinized for purposes of analyzing allocations applicable prior to the change.

- In addition, partnership allocations made pursuant to the partnership agreement to adjust partner capital accounts as a result of unanticipated capital contribution defaults or reductions will be disregarded in computing overall partnership income or loss for purposes of the fractions rule.
- The Proposed Regulations state that these adjustments may include allocations to adjust partners' capital accounts to be consistent with the partners' adjusted capital account commitment percentages.

- The Proposed Regulations do not appear to accommodate preferred allocations made to QOs as compensation for contributing capital that was otherwise due from a defaulting partner beyond the “reasonable preferred return” provision that is generally available with respect to any capital.

Unlikely Loss Exception

- Reg. § 1.514(c)-2(g) provides that allocations of unlikely losses or deductions are disregarded if principal purpose is not tax avoidance.
- Allocations must have “low likelihood of occurring”, taking into account all relevant facts, circumstances, and available information (including bona fide financial projections).

- When the unlikely loss rule was first outlined in Notice 90-41, the rule contained a “more likely than not” standard in determining whether a loss was unlikely. Replaced with “low likelihood”.
- The preamble to the new Proposed Regulations states that the IRS and Treasury are considering changing the “unlikely loss” standard from “low likelihood of occurring” to “more likely than not,” or some standard in between.
- Comments are requested concerning what is the appropriate standard.

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Chargebacks of the Specific Item

- The Proposed Regulations modify the chargeback exception to disregard certain additional items in computing overall partnership income or loss for purposes of the fractions rule.

- Specifically, an allocation of overall partnership income that is made to “chargeback” (reverse) a special allocation of a partner-specific expenditure or a special allocation of an unlikely loss will be ignored in applying the fractions rule.

Staged Closings

- Contrary to the ABA recommendations, the Proposed Regulations set forth provisions that are intended to accommodate staged closings in a very limited set of circumstances.
- If the conditions listed on the prior slide are satisfied, the IRS will not closely scrutinize changes in allocations resulting from staged closings for purposes of analyzing allocations applicable prior to the changes.

- Also, in computing overall partnership income or loss for purposes of analyzing the fractions rule after the changes, the IRS will disregard disproportionate allocations of income, loss, or deduction made to adjust the capital accounts when a new partner acquires its partnership interest after formation.
- Note, however, that the requirement of an interest rate factor not to exceed 150 percent of the highest applicable Federal rate will mean that very few arrangements will qualify under this provision.

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- The 18-month applicable period also may be problematic for some funds, particularly in difficult fund raising environments.
- The approach taken in the Proposed Regulations is significantly different than was proposed in the ABA Comments, and it can be expected that the IRS and Treasury will receive comments criticizing the narrow scope of the staged closing rule.

Staged Closings

- In order to satisfy the provision, the following conditions must be met to avoid “close IRS scrutiny”:

  (1) the new partner must acquire the partnership interest no later than 18 months following formation of the partnership (the “applicable period”),

  (2) the partnership agreement and other relevant documents anticipate the new partners acquiring the partnership interests during the applicable period, set forth the time frame in which the new partners will acquire the partnership interests, and provide for the amount of capital the partnership intends to raise,

(3) the partnership agreement and any other relevant documents specifically set forth the method of determining any applicable interest factor and for allocating income, loss, or deduction to the partners to adjust partners' capital accounts after the new partner acquires the partnership interest, and

(4) the interest rate for any applicable factor is not greater than 150 percent of the highest applicable Federal rate, at the appropriate compounding period or periods, at the time the partnership is formed.

LA 132954598

Tiered Partnerships

- Tiered partnerships - Where a qualified organization owns an indirect interest in real property through one or more tiers of partnerships, Reg. § 1.514(c)-2(m) provides that the fractions rule will be met only if:
  - Principal purpose of using tiers is not avoidance of tax; and
  - Relevant partnerships can demonstrate under any reasonable method that they satisfy the requirements of the fractions rule (examples illustrate methods).
  - Proposed Regulations amend third example to remove requirement that upper-tier partnership allocate lower-tier items separately from other items.

De Minimis Rule

- Under the current regulations, certain partnerships in which all QOs own 5% or less of the capital or profits interest in the partnership are exempt from application of the fractions rule.
- The Proposed Regulations adopt a rule to address the converse situation and provide that Proposed Regulations partnerships in which all partners (other than QOs) own 5% or less of the capital or profits interest in the partnership will be exempt from application of the fractions rule.

De Minimis Rule

- The current regulations also include a separate de minimis rule relating to de minimis allocations.
- Under the current rule, a disproportionate allocation of loss or deduction away from a QO will be treated as made to the QO if (1) the allocation was not tax motivated, and (2) the total amount of those items is less than both – (i) one percent of the partnership's aggregate items of gross loss and deduction for the taxable year, and (ii) $50,000.
- Under the Proposed Regulations increase the $50,000 amount to $1 million.

Partnership Audits

When the gods wish to punish us, they answer our prayers.

– Oscar Wilde, *An Ideal Husband*, 1893

How Did We Get Here?

- The GAO in 2014 published a report, Large Partnerships
  - *The Report concluded that the IRS lacked sufficient resources to effectively and efficiently audit, assess and collect taxes from partners in large partnerships.*
  - *Focus was on complicated, multi-tiered structures that could have thousands and in some cases millions of partners*
- Led to proposed (unworkable) legislation, which among other features not only assessed tax from audit adjustments at the partnership level, but also created joint and several liability on all the partners in a partnership for such taxes

How Did We Get Here?

- Revenue from the proposed legislation scored at nearly $10 billion leading tax writers to attach a revised version of their first draft to the Budget Act of 2016
- The Real Estate Roundtable and other industry groups worked with tax writers to improve the proposed legislation
- The revised version offered improvements from the original proposal dropping joint and several liability and making available for many partnerships an election out

The New Audit Rules – The Basics

- Examination at the Partnership Level [section 6221]
- Election Out [section 6221(b)]
  - Partnerships with not more than 100 partners
  - All partners are individuals, C Corporations, foreign entities taxed as C Corporations if domestic, S corporations, and estates of deceased partners
  - Applies to any taxable year in which election is made on a timely filed return
- Reviewed Year
  - Partnership taxable year to which the item being adjusted relates [section 6225(d)(1)]
- Adjustment Year
  - Partnership taxable year during which a Notice of Final Partnership Adjustment is received, a decision of a court becomes final, or administrative adjustment request is made

The New Audit Rules – The Basics

- Imputed Underpayments [section 6225]
  - Net of all adjustments that result with a net increase to taxable income
  - Multiplied by the highest applicable rate under sections 1 or 11
  - Reducing an Imputed Underpayment
    - Any partner amends its tax return for the taxable year under audit and includes the partners share of the audit adjustments on the amended return
    - Tax status of partners such as tax-exempts, qualified dividend income, or capital gains
  - Anomalies
    - An adjustment to the allocation of income among partners considers only increases and not decreases

The New Audit Rules – The Basics

- Push-out Election [section 6226]
  - Permits partners instead of the partnership to pay any additional tax liability
  - A revised Schedule K-1 is issued to the partners who were partners during the year under audit
    - Partners who were partners during the year being audited bear the burden of additional taxes
  - Partners report the adjustments in the year they receive a Revised Schedule K-1
  - Underpayment interest rate is increased by 2 percent when the Push-out Election is made
  - Operation and availability of “push-out” election is unclear under current law
    - Proposed technical corrections permit “push-out” through a multi-tiered partnership structure

Effect on Real Estate Investment Trusts

- UPREITs
  - Operating Partnerships with less than 100 partners, but if one partner is a partnership itself, “election out” is not available
  - Many Operating Partnerships may want to ensure all of its contributors are “qualifying” partners so it may avail itself of the election out.
  - Transfer restrictions
- Investments in Partnerships
  - Partnership level tax assessment has effect of imposing tax on the REIT that would not otherwise be imposed absent a reduced imputed underpayment
    - Not clear how REITs are treated
    - Was the REIT a partner in the Reviewed Year?
    - Potential deficiency dividend versus current year distribution

Effect on Real Estate Investment Trusts

- Partnership Representative
  - Has the power to bind the partnership and all partners in an administrative or judicial proceeding
  - Partners do not have the right to participate in any proceedings
  - Current partnership agreements and limited liability company operating agreements lack provisions governing how a partnership representative must act or refrain from acting
- Potential Issues for REITs and UPREITs
  - Does the REIT have the power to modify the Agreement?
  - Does modification require unanimous consent? Simple majority?
  - Does a partner with a relatively small interest have the ability to block modifications to the Agreement?

Effect on Real Estate Investment Trusts

- Partnership Representative (continued)
  - Examination Issues for REITs
    - Characterization of assets and income for the quarterly and annual REIT tests
    - Prohibited transaction issues
    - Hedge identification
  - Partnership Governance Provisions
    - Not binding on IRS or judicial tax proceeding
    - Legal remedies against Partnership Representative
      - *Indemnities*
      - *Jurisdiction*
    - Should the Agreement require a “Push-out” Election?
      - *Exception for de minimis adjustments*?

2017 Tasks

- Review existing Agreements
- Select Partnership Representative
- Amend Agreements
  - Partnership Representative
  - Governance
  - Push-out Elections
  - De minimis adjustments
  - Notice to Partners