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**"Real Estate Tax Update with Q and A"**

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May 12, 2011

## Three broad subjects:

- Enacted tax legislation (especially at the end of 2010)
- Technical tax developments (other than legislation)
- Possible tax legislation (crystal-ball gazing)

Only one rule: The only stupid question is the one you don't ask!

- Let's make this “interactive”
- Feel free to interrupt me with questions and comments
- From time to time I may ask you a question

## Part one: Enacted tax legislation (especially at the end of 2010)

- “Tax Relief Act of 2010”
  - (Technically: Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (PL 111-312))
    - Extends "Bush Tax Cuts"
    - Extends many otherwise expiring (or expired) provisions
  - Enacted 12/17/10

## Extension of “Bush Tax Cuts” (compared to Clinton-era rates)

- Marginal income tax rates on individuals max at 35%
- Capital gains and qualified dividends of individuals max at 15%

## History and Next Drama: “Bush Tax Cuts”

- Enacted 2001 (EGTRRA) and 2003 (JGTRRA)
- Had been scheduled to sunset end of 2010
- But in December 2010 Congress and Administration agreed to extend further
- Now scheduled to sunset end of 2012 (conveniently beyond next presidential election)
- Beginning in 2013, absent intervening legislation, individual tax rates will revert to Clinton-era rates:
  - Ordinary Income (including Dividends): 39.6% plus ...
  - Capital Gains: 20%

## Other Significant Features (Tax Relief Act of 2010)

- Reinstates modified estate and generation-skipping taxes
- Cuts payroll taxes for one year
- Temporarily extends many expiring (or expired) tax benefits for individuals and businesses including:
  - Marriage penalty relief
  - Unemployment insurance benefits
  - Election to deduct state and local general sales taxes
  - Credits for conserving energy
  - Research and development tax credit

# What do these temporary extensions mean for

- Individuals (including investors)?
- Businesses?

# Opportunities for individuals (including investors)

- Big picture ideas:
  - Tax-plan for two separate periods:
    - 2011 – 2012
    - After 2012
  - Accelerate income into first period; defer deductions into second period
- Caution: No one can predict what rates really might apply after 2012!

# Opportunities for individuals (including investors)

More detailed ideas: 2011 – 2012

- Hold investments:

- Taxable accounts: equities paying no or modest dividends
- Tax-deferred accounts: equities paying significant dividends; fixed income securities; stock in REITs

- Sell from taxable accounts:

- High-yielding stocks
- Highly appreciated assets (exceeding available offsetting capital losses)
- Inherited assets having modified carryover basis (under estate tax)

# Opportunities for individuals (including investors)

More detailed ideas: after 2012

- Emphasize tax-exempt and tax-deferred investments
- Hold in tax-deferred accounts:
  - Highly appreciated assets (exceeding available offsetting capital losses)
  - High-yielding equities and other investments
- Defer selling from taxable accounts:
  - Highly appreciated assets (exceeding available offsetting capital losses)
  - Low-yielding equities

# Opportunities for corporations

- 2011 and 2012:
  - Prefer equity financing over debt financing (all other factors equal)
  - Accelerate paying dividends
- After 2012:
  - Equity and debt financing more equally weighted
  - Defer paying dividends

## Other temporary relief for individuals

- Estate and generation-skipping taxes: modified and reinstated through 2012
- Cap on itemized deductions: repealed through 2012
- Personal exemptions phaseout: repealed through 2012
- State and local taxes: through 2012, can elect to deduct either sales taxes or income taxes
- Charitable conservation contributions of real property: extended through 2011
- Residential energy property credit: modified and extended through 2011
- Gain on selling or exchanging qualified small business stock: exclusion extended through 2011; AMT relief extended through 2012

## Other temporary relief for businesses

- Bonus depreciation: 100% deduction for qualified property acquired and placed in service before 2012; other enhancements extended
- Code section 179 expensing: limitations increased to \$125,000/\$500,000 for tax years beginning in 2012
- Leasehold improvements depreciation: 15-year recovery extended through 2011
- Research and development tax credit: extended through 2011
- New markets tax credit: extended through 2011
- Builder's credit for constructing or manufacturing new energy efficient homes: extended through 2011
- Manufacturer's credit for energy efficient appliances: modified and extended through 2011

# Tax Rates after 2012?

- Importance of maintaining parity in rates
  - Capital Gains
  - Dividends

## Part Two: Technical tax developments (other than legislation)

- Statute of limitations for assessing tax on partnership items
- Partnership anti-abuse rule
- Partnership "varying interests" rule
- Distressed property; workouts
  - Cancellation of indebtedness ("COD") income
  - Modifications of debt instruments
- Partnership disguised sales

## Part Two: Technical tax developments (other than legislation)

- Series LLCs
- Economic substance doctrine
- Carried interests
- Like-kind exchanges
- Passive activities
- Real estate investment trusts

## Part Two: Technical tax developments (other than legislation)

- S corporations
- Home builders
- Charitable contributions: facades, easements, etc.
- Bonus depreciation
- Foreign tax credits
- Tax aspects of leasing

# Statute of limitations on partnership items

## ■ Rules:

- General Rule: IRS must assess tax deficiency with respect to any partnership item within three years after the later of
  - Partnership return filing date, or
  - Deadline for filing partnership return (disregarding extensions)
- Exception: If partnership substantially omits gross income, then IRS has six years instead of three years to assess tax deficiency
- Parallelism: Same general rule and exception (among others) apply outside partnership context
- Substantial omission: An amount exceeding 25% of the gross income stated in the return

## Statute of limitations on partnership items

- Issue: Does a partnership substantially omit gross income if it overstates basis in property thereby understating gain from selling the property?
- IRS: Yes; final regulations under IRC sections 6229(c) and 6501(e)(1)
- Courts: Inconsistent decisions
  - No (overstated basis does not omit gross income)
    - *Bakersfield Energy Partners v. Commissioner* (9<sup>th</sup> Cir. 2009)
    - *Salman Ranch Ltd. v. US* (Fed. Cir. 2009)
    - *Intermountain Insurance Service of Vail LLC v. Commissioner* (Tax Court 2009; on appeal to DC Cir.)
  - Yes (overstated basis omits gross income)
    - *Home Concrete & Supply, LLC v. US* (District Court 2008)
    - *Brandon Ridge Partners v. US* (District Court 2007)
    - *Burks v. US* (District Court 2008, on appeal to 5<sup>th</sup> Cir.)

# Partnership anti-abuse rule

- IRC Section 701
  - Partnerships themselves not subject to income tax
  - Partners liable for income tax only in their separate or individual capacities
- Reg. Section 1.701-2: Empowers IRS to recast a transaction to achieve tax results consistent with the intent of IRC Subchapter K
  - Disregard “purported partnership”;
  - Disregard “purported partner(s)”;
  - Adjust tax accounting methods to “reflect clearly” income;
  - Reallocate partnership items; or
  - Otherwise adjust or modify claimed tax treatment

## Partnership anti-abuse rule

- Court cases: For the first time, courts have applied Reg. Section 1.701-2
  - *Nevada Partners Fund LLC v. US* (District Court 2010)
  - *Fidelity International Currency Advisor A Fund LLC v. US* (District Court 2010)

# Partnership "varying interests" rule

- IRC 706 (d)
  - Gen. rule: If during a taxable year any partner's interest in a partnership changes, the partnership must determine each partner's distributive shares by taking into account the partners' varying interests in the partnership during that taxable year
- Special rules:
  - Cash basis items: Must prorate among the partners on a daily basis
  - Tiered partnerships: If any partner's interest in an upper tier partnership changes during the year, then must apply varying interests rule to items from lower tier partnership

## Partnership "varying interests" rule

- Prop. Reg. 1.706-4 (April 2009):
  - Fundamental principle: must determine partners' varying interests by using the interim closing method unless the partners agree to use the proration method; must apply the same method consistently for the same year
  - Segments: Must divide taxable year into "segments"

# Partnership "varying interests" rule

- Prop. Reg. 1.706-4 (April 2009) exceptions and safe harbors
  - Contemporaneous partners exception
  - Service partnership safe harbor
  - Publicly traded partnership units safe harbor

## Partnership "varying interests" rule

- Prop. Reg. 1.706-4 (April 2009) conventions
  - Calendar day convention
  - Semi-monthly convention
- Effective date: partnership taxable years that begin after the date regulations are finalized

# Distressed property; workouts

- Two perspectives:
  - Debtor
  - Creditor

## Distressed property; workouts

- Debtor perspective: two issues
  - Recognize cancellation of indebtedness ("COD") income?
  - Recognize gain upon transferring encumbered property to satisfy debt?

## Distressed property; workouts

- Debtor perspective: COD income?
- General rule:
  - Except as the Code otherwise provides, gross income means all income from whatever source derived. IRC 61(a)(1)
  - Gross income includes income from discharge of indebtedness. IRC 61(a)(12)

## Distressed property; workouts

- Debtor perspective: COD income?
- Exceptions: Debtor does not recognize COD income
  - Title 11 (bankruptcy) case
  - Debtor insolvent
  - Qualified farm indebtedness
  - Qualified real property business indebtedness (other than C corporations)
  - Qualified principal residence indebtedness

## Distressed property; workouts

- Debtor perspective: COD income?
  - "Toll charge" for not recognizing COD income: debtor must reduce one or more tax attributes; mechanics vary by exclusion
  - Consequently, excluded COD income deferred, not permanently forgiven

## Distressed property; workouts

- Debtor perspective: COD income?
- Most recent developments:
  - Election to defer and ratably recognize COD income from reacquiring an applicable debt instrument: IRC 108(i)
  - Administrative interpretations of IRC 108(i):
    - Revenue Procedure 2009-37
    - Temporary Regulations

## Distressed property; workouts

- Debtor perspective: COD income?
- IRC 108(i) fact pattern: taxpayer (debtor) reacquired an applicable debt instrument--
  - After December 31, 2008, and
  - Before January 1, 2011

## Distressed property; workouts

- Debtor perspective: COD income?
- Debtor under IRC 108(i) may elect to defer recognizing COD income
  - Ratably over five taxable years
  - Recovery period begins fifth taxable year following acquisition in 2009 or fourth taxable year following acquisition in 2010

# Distressed property; workouts

- Debtor perspective: COD income?
- Definitions: IRC 108(i)
  - Applicable debt instrument: issued by
    - A C Corporation, or
    - Any other person in connection with the conduct of a trade or business
  - Qualifying reacquisition: by either the debtor or a related person
  - Acquisition:
    - Cash
    - Exchange debt instrument for another debt instrument
    - Exchange debt instrument for corporate stock or a partnership interest
    - Contribute debt instrument to capital
    - Holder completely forgives debt

## Distressed property; workouts

- Debtor perspective: COD income?
- Mechanics of electing to defer COD income under IRC 108(i):
  - Must elect deferral in return of tax for taxable year in which reacquisition occurred
  - Must clearly identify the debt instrument and state the amount of COD income for which election made
  - Election irrevocable
  - Pass-through entities (partnership, S corporation, or other): entity must make the election
- Details: Revenue Procedure 2009–37

## Distressed property; workouts

- Debtor perspective: COD income?
  - Cannot "double dip"
  - Can't both elect to defer recognizing COD income under IRC 108(i) and also exclude the income under one of the exclusion categories

## Distressed property; workouts

- Debtor perspective: COD income?
- Partnerships: must allocate deferred COD income among the partners in accordance with IRC Section 704 (generally applicable rules for allocating items among partners)
- Section 108(i) temporary regulations: focus on partnerships and S corporations
  - Safe harbor for treating debt instrument as issued in connection with conduct of a trade or business
  - Rules for determining deferred OID deductions
  - Adjustments to basis, capital account, and accumulated adjustments accounts
  - Specific acceleration and non-acceleration events
  - Coordination with recapture of amounts at risk (IRC 465(e))

## Distressed property; workouts

- Debtor perspective: gain upon transferring encumbered property to settle debt?
- Threshold distinction:
  - Sale or exchange transaction, or
  - Debt forgiveness transaction?

## Distressed property; workouts

- Debtor perspective: gain upon transferring encumbered property to settle a debt?
- Fundamental principle: if debtor transfers to a creditor property subject to nonrecourse indebtedness in complete satisfaction of the debt--
  - Debtor's amount realized does not exceed the amount of the nonrecourse debt encumbering the property
  - Debtor's gain (if any) equals amount by which nonrecourse debt balance exceeds debtor's adjusted basis in the transferred property
- Reg. 1.1001-2
- *Fulton Gold; Crane; Tufts*

## Distressed property; workouts

- Creditor perspective: taxable modification of a debt instrument?
- If so, then creditor must recognize gain or loss equaling difference between—
  - Face amount of the modified debt, and
  - Creditor's basis in the modified debt
- Reg. 1.1001-1(a)

## Distressed property; workouts

- Creditor perspective: taxable modification of debt instrument?
  - Yes, if a *significant* modification
  - Reg. 1.1001-3; *Cottage Savings Association*

## Distressed property; workouts

- Creditor perspective: taxable modification of debt instrument?
  - Modification of debt instrument that results in something not debt for tax purposes = significant modification. Reg. 1.1001-3(e)(5)(i)
  - Prop. Reg. 1.1001-3: To determine whether modified instrument "debt"--
    - Any deterioration in issuer's financial condition between date instrument issued and date altered or modified (concerning issuer's ability to repay) not taken into account unless new obligor substituted or co-obligor added or deleted
    - Any decrease in FMV of instrument (whether or not publicly traded) between date issued and date altered or modified not taken into account to extent that decrease in FMV attributable to deterioration in issuer's financial condition and not to modification of instrument's terms

# Partnership disguised sales

- Fact pattern:
  - Partner (existing or incoming) transfers property to a partnership, and
  - Partnership distributes cash or other property to contributing partner

# Partnership disguised sales

- Characterization:

- Tax-free contribution (IRC 721 (a)), followed by tax-free distribution to extent of outside basis (IRC 731) (a), or
- Taxable sale of property between partner and partnership (or between partners) (IRC 707 (a))?

# Partnership disguised sales

- Reg 1.707-1 through 8
  - Two-year presumptions
  - Facts and circumstances analysis
  - Associated rules

# Partnership disguised sales

## ■ Judicial interpretations:

- *United States v. G-I Holdings Inc.* (Bankruptcy Court 2009):
  - Purported loan to partner recast as loan to partnership
  - Disguised sale
- *Canal Corporation v. Commissioner* (Tax Court 2010):
  - Exception for debt-financed distributions did not apply
  - Disguised sale
  - Accuracy-related penalty (IRC Section 6662 (a))

# Series LLCs

- Issue: how to classify for tax purposes.
  - Series LLC?
  - Each constituent series?

## Series LLCs

- Proposed regulations (September 2010): threshold question
  - Should an individual series be considered an entity for federal tax purposes?

# Series LLCs

- Proposed regulations (September 2010): analysis
  - Domestic series generally treated for federal tax purposes as entities formed under local law.
  - A domestic series, whether or not a juridical person for local law purposes, treated as an entity formed under local law.
  - Whether a series treated as a local law entity to be recognized as a separate entity for federal tax purposes: apply generally applicable classification rules; see Reg. Section 301.7701-1 (b)

# Economic substance doctrine

- Origin: court cases
  - Courts have disallowed claimed tax benefits from transactions found to lack "economic substance"
  - Siblings:
    - Substance over form
    - Step transaction
    - Sham transaction
    - Lack of business purpose

# Economic substance doctrine

- IRC Section 7701 (o) (March 2010): “Clarification of economic substance doctrine”
  - Terms
  - What it does
  - What it does not do
  - Potential penalties

# Economic substance doctrine

## ■ IRC Section 7701 (o): terms

- If economic substance doctrine is "relevant," then the transaction will be treated as having economic substance only if—
  - Transaction changes in a meaningful way (apart from federal income tax effects) taxpayer's economic position, and
  - Taxpayer has a substantial purpose (apart from federal income tax effects) for entering into the transaction
- Potential profit taken into account only if present value of reasonably expected pre-tax profit substantial in relation to present value of expected net tax benefits that would be allowed if transaction respected.
- Any state or local income tax effect related to a federal income tax effect treated same as federal income tax effect.
- Achieving a financial accounting benefit not taken into account as a qualifying purpose if origin of accounting benefit a reduction of federal income tax.

# Economic substance doctrine

- Statutory definition: The common law doctrine under which tax benefits with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.

# Economic substance doctrine

- IRC section 7701 (o): what it does
  - In order to have economic substance, both of two requirements must be satisfied.
  - Imposes significant penalties if transaction found to lack economic substance

# Economic substance doctrine

- IRC section 7701 (o): what it does not do
  - Prescribe when the economic substance doctrine is “relevant”
  - Explain how the government is supposed to apply the doctrine

# Economic substance doctrine

- Potential penalties if economic substance lacking
  - Accuracy-related penalty 40% (rather than the usual 20%)
  - General reasonable cause exception for accuracy-related and fraud penalties not available
  - Any excessive claim for refund attributable to any transaction lacking economic substance cannot have a reasonable basis

## Economic substance doctrine

- IRC interpretations: Notice 2010-62 (September 2010)
  - IRS will continue to rely on relevant case law to analyze when economic substance doctrine applies (same analysis as before Section 7701 (o) enacted)
  - Unless a reportable transaction, adequate disclosure requirements (IRC Section 6662 (i)) satisfied if taxpayer adequately discloses relevant facts on timely filed original return (including extensions) or a qualified amended return; must disclose facts on Form 8275 or 8275-R
  - IRS will not issue private letter rulings regarding whether economic substance doctrine relevant or whether transaction complies with IRC Section 7701 (o)
- LMSB Directive (September 2010): A proposal to impose an economic-substance penalty must be reviewed and approved by the appropriate IRS Director of Field operations

# Carried interests

- Current law:
  - Transfer of partnership profits interests in exchange for services generally not taxable to service provider or partnership
  - If a partnership grants a substantially non-vested partnership profits interest, service provider treated as receiving interest on date of grant (rather than later date interest substantially vests)
  - IRC Section 83 does not apply; recipient need not make Section 83 (b) election
- Rev. Procs. 93-27; 2001-43

# Carried interests

- Proposed regulations: compensatory partnership interests
  - IRC Section 83 applies to issuances of compensatory partnership interests
  - Recipient may elect under IRC Section 83 (b)

# Carried interests

- Proposed legislation: two issues
  - Taxability of receiving carried interest
  - Character of allocable income from carried interest

# Carried interests

- Proposed legislation:
  - Interest taxable upon receipt
  - Recipient must recognize FMV as though Section 83 (b) election made

# Carried interests

- Proposed legislation: taxation of allocable income
  - Holder must treat distributive share of partnership items from an investment services partnership interest as ordinary income for the performance of services, subject to limitations
  - Applicable percentage (50% of 75%, depending on year) of gain or loss recognized on disposing of investment services partnership interest treated as ordinary income

# Carried interests

- Proposed legislation: investment services partnership interest
  - Advising on, investing in, purchasing, or selling any specified asset;
  - Managing, acquiring, or disposing of any specified asset; or
  - Arranging financing with respect to acquiring specified assets.
- "Specified asset" means securities, real estate, interests in partnerships, commodities, or options or derivative contracts with respect to any of them

# Carried interests

- Proposed legislation: penalties

- 40% accuracy-related penalty if taxpayer reports an amount as not subject to new rules and treatment not sustained
- Penalty would not apply if taxpayer (i) adequately discloses, (ii) has substantial authority, and (iii) reasonably believes tax treatment more likely than not proper

## Like-kind exchanges

- Safe-harbor method for reporting gain from failed exchange because bankrupt QI did not timely acquire and transfer replacement property. Rev. Proc. 2010-14 (March 2010)
- Exchange failed to qualify for nonrecognition treatment because taxpayers did not prove primary purpose of holding replacement property for investment or productive use in a trade or business. *Goolsby v. Commissioner* (Tax Court 2010)
- Exchange failed because economic equivalent of a direct related-party exchange disallowed nonrecognition treatment under IRC Section 1031 (f). *Ocmulgee Fields Inc. v. Commissioner* (11th Cir. 2010)

## Passive activities

- LLC member not limited partner and, therefore, may test for material participation under all seven regulatory tests. Various judicial decisions.
- Taxpayers must report on Form 8582 worksheets groupings of activities and certain changes. Rev. Proc. 2010-13 (January 2010)

## Real estate investment trusts

- Relief for qualifying distributions made by REITs and RICs in 2010 and 2011: Rev. Proc. 2010-12 (December 2009)
- IRS will not challenge the status of mortgage loans held by a REMIC as other than a "qualified mortgage" on grounds that the mortgage loan fails to be principally secured by an interest in real property. Rev. Proc. 2010-30 (August 2010)

# S corporations

- Shareholder's guarantying S corporation's line of credit did not increase shareholder basis in S corporation. *Weissberg v. Commissioner* (Tax Court 2010)

## Part Three: Possible tax legislation (crystal-ball gazing)

- Three questions:
  - What might happen?
  - When might it happen?
  - What should you do now (not later)?