April 29, 2014

The Honorable Jacob J. Lew
Secretary of the Treasury
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

The Honorable John A. Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20024

RE: Proposed Regulations Regarding Allocations of Partnership Liabilities (REG–119305–11)

Dear Secretary Lew and Commissioner Koskinen:

This letter is submitted on behalf of the undersigned national real estate organizations (NREO), which support the views set forth in the letter dated April 28, 2014 by The Real Estate Roundtable regarding the above-referenced proposed regulations. After carefully reviewing the proposed regulations regarding the allocation of partnership recourse and nonrecourse liabilities under section 752[1] (the Proposed Regulations), NREO wishes to convey its concern regarding the negative impact that the Proposed Regulations could have on real estate owners, including partnerships, limited liability companies and real estate investment trusts (REITs). NREO understands that the primary motivation for these proposed changes was to curtail the ability to structure certain leveraged partnership distribution transactions that currently qualify for an exception to disguised sale treatment under the section 707 regulations. Instead of making targeted changes to the section 707 regulations to address the concerns of the Treasury Department (Treasury) and the Internal Revenue Service (IRS), the Proposed Regulations would make sweeping, and in many cases, unworkable, changes to the existing rules for allocating partnership liabilities.

The many problems with the Proposed Regulations have been detailed by a number of commentators[2] and, based on many of the issues raised in these articles, NREO supports the withdrawal or substantial revision of the Proposed Regulations. In addition, NREO supports a more generous effective date and transition rule so that existing arrangements could be treated in a way that allows taxpayers to keep the terms they negotiated under the existing, long-established rules.

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[1] Section references contained herein are to the Internal Revenue Code of 1986, as amended (the "Code") or to Treasury regulations promulgated thereunder.

[2] *See* Blake D. Rubin, Andrea M. Whiteway, and Jon G. Finkelstein, *A "Guaranteed" Debacle: Proposed Partnership Liability Regulations*, 143 Tax Notes 219 (April 14, 2014); Richard M. Lipton, *Proposed Regulations on Debt Allocations: Controversial and Deservedly So*, 120 J. Tax 4 (April 2014).

NREO is particularly concerned that the Proposed Regulations would inappropriately impose a substantial restriction on the ability to transfer appreciated real estate to partnerships on a tax-deferred basis, including in the context of the formation of an umbrella partnership REIT (UPREIT). In an UPREIT structure, a REIT forms an operating partnership and transfers cash and assets to the partnership in exchange for a general partner interest. Individual real property owners contribute their property to the operating partnership in exchange for limited partner interests; under the basic principles of section 721[3], these contributions generally are tax-deferred until the partner sells or redeems his or her interest in the partnership. Partnership interests in the operating partnership are typically referred to as Operating Partnership (OP) Units. The limited partner's OP Units are generally redeemable for cash or, at the REIT's election, exchangeable for a share of the REIT's stock on a one-for-one basis, and the exchange of OP Units for REIT stock is a taxable transaction.

UPREITs allow property owners to diversify their investments on a tax-deferred basis. The contribution of property subject to debt in excess of the contributing partner's tax basis to the OP does not result in the recognition of gain to the property owner to the extent the contributing partner retains a sufficient allocable share of the OP's debt. In some cases, a contributing partner may enter into a guaranty of nonrecourse debt encumbering the contributed property to maintain a sufficient share of the OP's debt. However, in some instances, OPs refinance debt encumbering specific property with a general recourse line of credit. In those cases, under both the current section 752 regulations and the Proposed Regulations, a guaranty of any portion of the operating partnership's recourse line of credit by a contributing partner may not cause any of the debt to be allocated to the contributing partner because the REIT, as the general partner, is deemed to bear the economic risk of loss for such debt. In those cases, a contributing partner may enter into a capital account deficit restoration obligation (a DRO), which, under the current section 752 regulations, will result in an allocation of a portion of the OP's recourse liability to the contributing partner.

The UPREIT structure is expressly validated in the section 701 regulations as consistent with the intent of the partnership tax rules in subchapter K of the Code. Treas. Reg. § 1.701-2(d), Example 4, outlines an UPREIT formation transaction pursuant to which real property owners contribute property subject to debt in excess of basis to an operating partnership to avoid the application of sections 351(e) and 357(c), which would trigger the property owners' built-in gain if the property were contributed to the REIT. The example states that "Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. . . . The decision to organize and conduct business through [a partnership] . . . is consistent with this intent." Notwithstanding this approval, the Proposed Regulations would substantially restrict the ability to effectively utilize UPREIT structures.

Under the current section 752 regulations, a partnership liability is allocated to a partner as a partnership recourse liability to the extent that such partner bears the "economic risk of loss" for the liability under a "constructive liquidation test." Under that test, a partner is treated as bearing

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[3] For purposes of this letter, "section" refers to the Internal Revenue Code of 1986, as amended.

the economic risk of loss for a partnership liability to the extent that the partner or a person related to the partner would be obligated to make a payment because the liability becomes due and payable upon a deemed liquidation of the partnership when the partnership's assets are worthless. The application of the constructive liquidation test is relatively mechanical and administrable in that it generally takes into account any legally binding payment obligation entered into by a partner or related person and presumes that the obligation will be satisfied, subject to a net value requirement for disregarded entities and an anti-abuse rule.

The Proposed Regulations would drastically alter the current regime by imposing the following seven "recognition requirements" that would need to be satisfied in order for a legally binding payment obligation to be taken into account:

1. The obligor must maintain a commercially reasonable net worth throughout the term of the payment obligation, or be subject to commercially reasonable contractual restrictions on transfers of assets for inadequate consideration.
2. The obligor must be required to periodically provide commercially reasonable documentation regarding the obligor's financial condition.
3. The term of the obligation must not end prior to the term of the partnership liability.
4. The payment obligation must not require that the primary obligor or any other obligor with respect to the partnership liability directly or indirectly hold money or other liquid assets in an amount that exceeds the reasonable needs of such obligor.
5. The obligor must receive arm's length consideration for assuming the payment obligation.
6. In the case of a guarantee or similar arrangement, the obligor must be liable up to the full amount of such obligor's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied.
7. In the case of an indemnity, reimbursement, or similar arrangement, the obligor must be liable up to the full amount of its obligation if, and to the extent that, any amount of the indemnitee's or other beneficiary's payment obligation is satisfied.

In the preamble to the Proposed Regulations, Treasury and the IRS state that the imposition of the recognition requirements is intended to fulfill Congress's directive in the Deficit Reduction Act of 1984 ("DEFRA") to promulgate regulations under section 752 that only give effect to bona fide commercial obligations. Many of the recognition requirements are completely subjective and non-commercial. For example, it is extremely difficult to discern the meaning of "commercially reasonable" in the first and second recognition requirements, "reasonable needs" in the third recognition requirement, and "arm's length" in the fifth recognition requirement.

Further, there are clearly instances when a lender will not require net worth maintenance covenants from a guarantor. In addition, in a wide array of transactions when guarantees are prevalent, a guarantee fee is very often not paid. As a result, unlike the current regulations, the Proposed Regulations would not be administrable, would fail to recognize legally binding payment obligations, and would impose non-commercial requirements on every payment obligation undertaken with respect to a partnership liability.

In addition, the Proposed Regulations appear to be directly contrary to the intent of Congress. In DEFRA, Congress specifically directed Treasury to issue regulations under section 752 that would reject the holding in *Raphan v. United States*.[4] In that case, the Claims Court disregarded partnership liability guarantees from the general partners, which resulted in an allocation of a share of the liability to the limited partners. The guarantors did not receive arm's length consideration from the partnership for their guarantees. In the conference report for DEFRA, Congress directed Treasury to revise the section 752 regulations "to take account of current commercial practices and arrangements, such as assumptions, guarantees, indemnities, etc." and specifically stated that "the decision in the *Raphan* case is not to be followed for purposes of applying section 752 or the regulations thereunder. . . . [T]he conferees intend that the revisions to the section 752 regulations will be based largely on the manner in which the partners, and persons related to the partners, share the economic risk of loss with respect to the partnership debt . . . ." As noted above, the guarantors in *Raphan* did not receive arm's length consideration from the partnership. As a result, the guarantees would fail the fifth recognition requirement in the Proposed Regulations and would be disregarded, just as they were disregarded by the Claims Court. This calls into question whether the Proposed Regulations are valid.

The imposition of the recognition requirements would also negatively impact any real estate partnership, including an UPREIT OP, when contributing partners must rely on DROs to prevent the recognition of built-in gain. Although a DRO constitutes a valid, and in some cases, required obligation under the section 704(b) regulations, [5] it is unlikely that a DRO can satisfy all of the recognition requirements in the Proposed Regulations. For example, to be valid under the section 704(b) regulations, a DRO must be satisfied by the later of the end of the taxable year during which a partner's interest in the partnership is liquidated or 90 days after the date of such liquidation. Accordingly, a DRO may become due and payable prior to the term of the partnership's liability in violation of the third recognition requirement. In addition, a contributing partner does not receive a fee for entering into a DRO in violation of the fifth recognition requirement.

A DRO would also not satisfy the sixth recognition requirement. Although the sixth recognition requirement is ostensibly intended to disregard so called "bottom guarantees," its reach is potentially much broader and would disregard any payment obligation that does not require a payment equal to the lesser of the amount of any shortfall in the repayment of the partnership liability or the full amount of the payment obligation. In order for a DRO to be due and payable upon the liquidation of the obligor's partnership interest, a loss must be allocated to the obligor that results in a deficit capital account. A properly structured DRO would become due and payable under the constructive liquidation test where the partnership's assets are deemed

[4] 3 Cl. Ct. 457 (1983), rev'd on this issue, 759 F. 2d 879 (Fed. Cir. 1985).
[5] Treas. Reg. § 1.704-1(b)(2)(ii)(b)(3).

worthless. However, a DRO may not become due and payable if the partnership's assets have a value at least equal to their tax basis, even if the partnership's liabilities are not fully satisfied.[6] Accordingly, the sixth recognition requirement would be violated. As a result, a DRO entered into by a partner in an OP could not be taken into account as a payment obligation under the Proposed Regulations, notwithstanding that DROs are a key component of the section 704(b) regulations. This change to the treatment of DROs would in many cases prevent the formation of a wide range of real estate partnerships, including an UPREIT's OP, which is a valid commercial transaction that has been specifically approved by the section 701 regulations.

Finally, many existing guaranty arrangements allow the OP to repay or refinance debt for a period of time so long as the contributing partner is given the opportunity to guaranty other OP debt (including, usually, the refinancing debt). It is not clear whether a continuous guarantee of other OP debt – including debt which merely replaces refinanced debt and is secured by the same assets – would be treated as a new obligation subject to the Proposed Regulations. Surely, the Proposed Regulations are not intended to disincentivize partnerships from acting as prudent real estate investors by reducing borrowing costs and refinancing or moving to a different leverage structure.

Moreover, in many instances, the seven-year transition rule in the Proposed Regulations inadequately protects existing arrangements. Taxpayers who negotiated agreements under the existing section 752 regulations and with the knowledge of years of IRS acceptance of what has become a common part of the real estate landscape should be able to keep the benefit of their bargains.

To change the rules so dramatically without grandfathering existing arrangements is tantamount to retroactive legislation. Such retroactive application of new tax rules on transactions completed under prior law would harken back to Congress' retroactive application of the passive loss rules in the Tax Reform Act of 1986. Many commentators have concluded that such retroactive application was a significant factor in causing the savings and loan crisis of the late 1980s and the subsequent economic dislocation to the overall economy.[7]

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[6] *See* Rubin, Whiteway and Finkelstein, *supra* note 2, at 226.

[7] *See, e.g.*, Federal Deposit Insurance Corp. *History of the Eighties—Lessons for the Future.* Vol 1: *An Examination of the Banking Crises of the 1980s and Early 1990s* (1997) 138, 141 ("The consequences of these provisions was to dampen the demand for commercial real estate investments during the late 1980s and early 1990s, and the dampening of demand helped soften real estate prices"); Stanley D. Smith, Larry R. Woodward and Craig T. Schulman, *The Effect of the Tax Reform Act of 1986 and Overbuilt Markets on Commercial Office Property Values*; 19 J. REAL ESTATE RESEARCH 301, 317 (2000) ("The results indicate that the TRA86 did have a significant negative effect on values in all four regions [of the U.S.]"); Stanley D. Smith and Larry R. Woodward, *The Effect of the Tax Reform Act of 1986 and Regional Economies on Apartment Values,* 11 J. REAL ESTATE RESEARCH 259, 270 (1994) ("results indicate that overall the Tax Act of 1986 had a *significant* negative impact on apartment values"); Gary C. Sanger, C. F. Sirmans and Geoffrey K. Turnbull, *The Effects of Tax Reform on Real Estate: Some Empirical Results*, 66 J. LAND ECONOMICS 409, 421 (Nov. 1990) ("results suggest that passage of the 1986 TRA had similar negative implications for both REITs and non- REIT real estate firms").

In summary, we believe that the Proposed Regulations would impose subjective and non-commercial requirements on all payment obligations entered into by partners that would not be administrable or consistent with Congressional intent. In addition, these requirements would limit the ability to contribute property to real estate partnerships in a tax deferred manner and would undercut existing agreements negotiated under existing, long-standing regulations.

Accordingly, NREO urges Treasury and the IRS to withdraw the Proposed Regulations or at least to substantially revise them to reflect the issues raised by this letter. To the extent that Treasury and the IRS continue to have concerns regarding leveraged partnership distribution transactions, NREO suggests that targeted changes to the partnership disguised sale regulations under section 707 be implemented to specifically address those concerns and not apply the Proposed Regulations to partnership allocations that were made in compliance with existing rules. Please contact Tony Edwards, NAREIT's Executive Vice President & General Counsel, at tedwards@nareit.com if you would like to discuss this letter in greater detail.

Respectfully submitted,

American Seniors Housing Association
Building Owners and Managers Association International
International Council of Shopping Centers
NAIOP, Commercial Real Estate Development Association
National Apartment Association
National Association of Real Estate Investment Trusts
National Multifamily Housing Council

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