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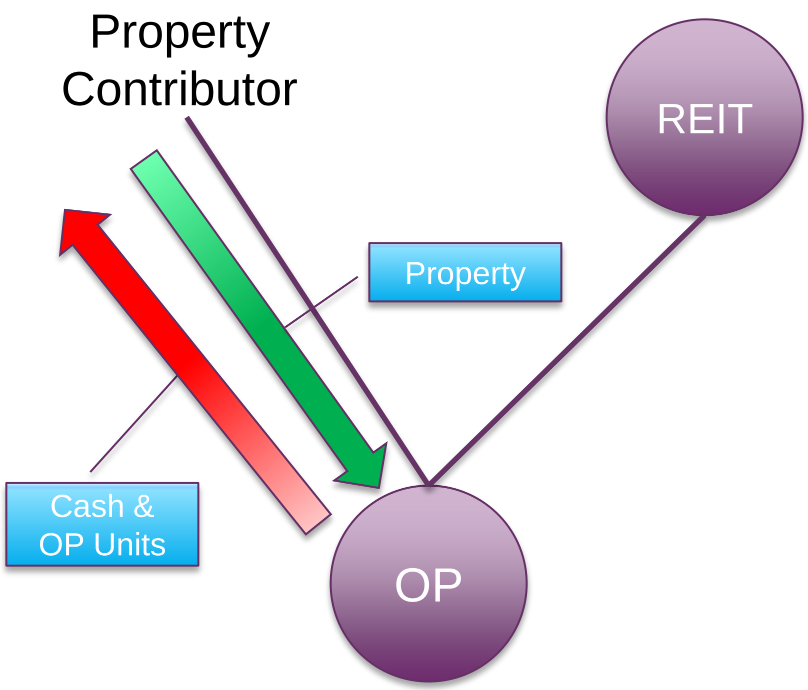
®

Partnership Tax Issues Encountered by REITs

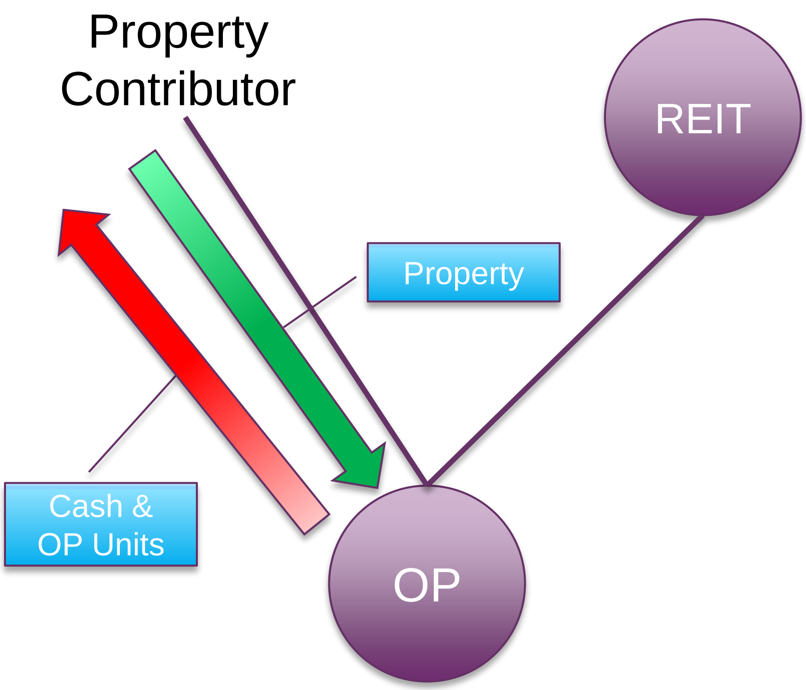
April 1, 2015

Disguised Sales and Liabilities



- Property Contributor contributes real estate to up-REIT OP.
- Receives OP Units and cash.
- Task: avoid gain on contribution & receipt of cash.

Disguised Sales and Liabilities



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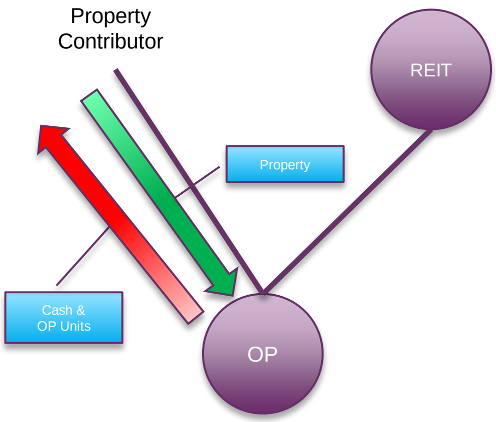
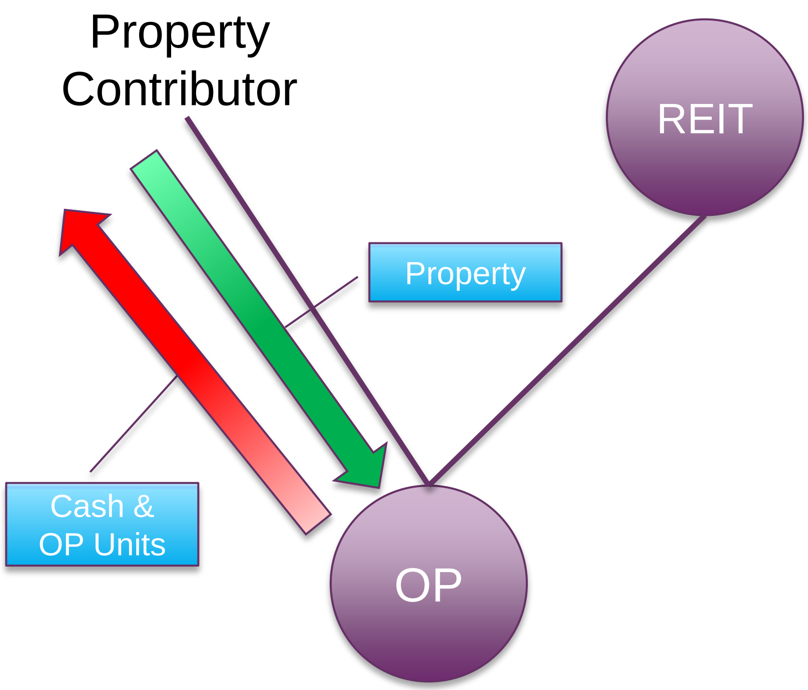


Contributed Property

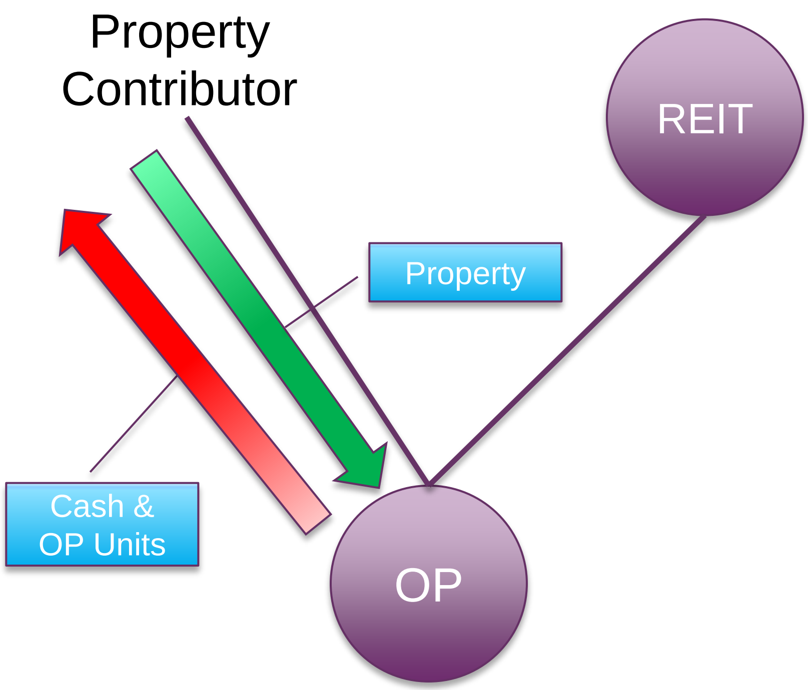
	Adjusted Basis	FMV
Land	$3,000,000	$10,000,000
Building	$3,000,000	$32,000,000
Total	$10,000,000	$42,000,000
Liabilities	$12,000,000	$12,000,000
Total	($2,000,000)	$30,000,000

Disguised Sales and Liabilities



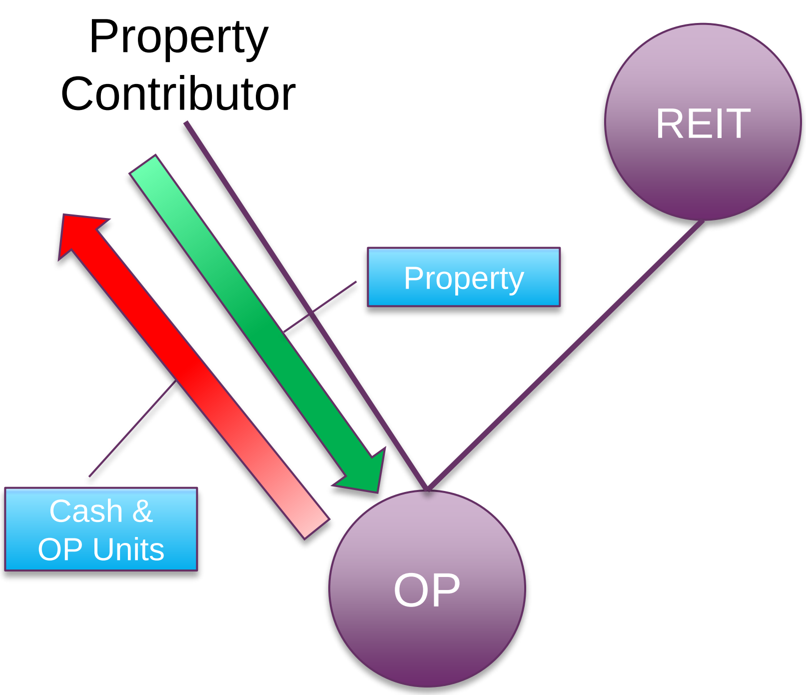
- Considerations:
  - Disguised sale.
  - Liability relief.
  - At risk recapture.

Disguised Sales and Liabilities



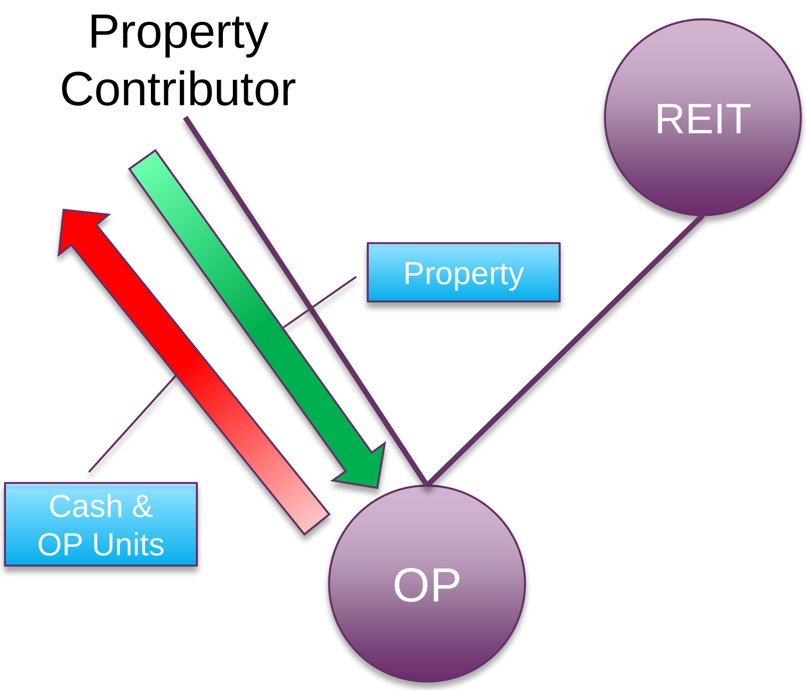
- Disguised sales.
  - Assumption of nonqualified liabilities incurred within 2 years of contribution.
  - Large cash distributions within 2 years of contribution.

Disguised Sales and Liabilities



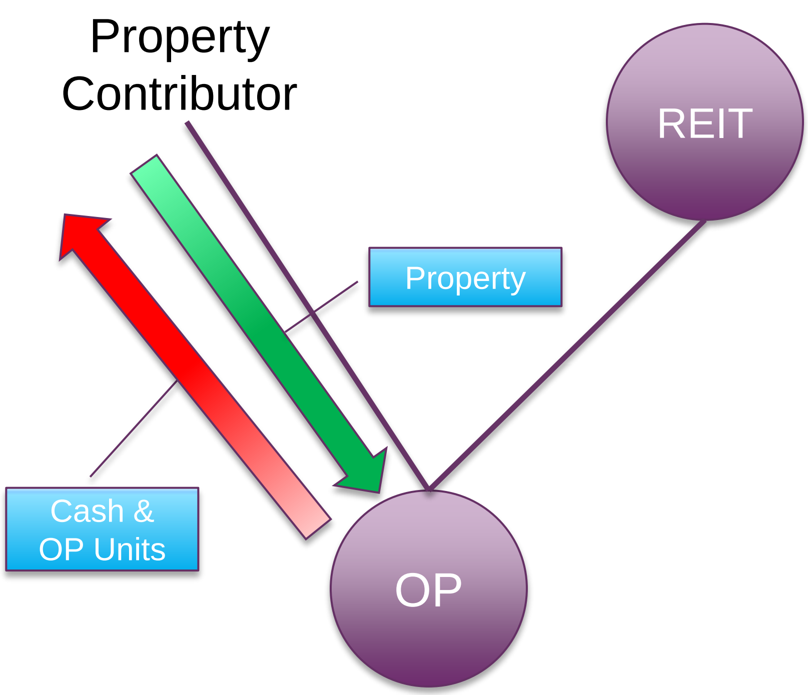
- Liabilities.
  - Relief creating “negative basis” results in gain.
  - Relief of qualifying nonrecourse debt can create at risk recapture.

Disguised Sales and Liabilities



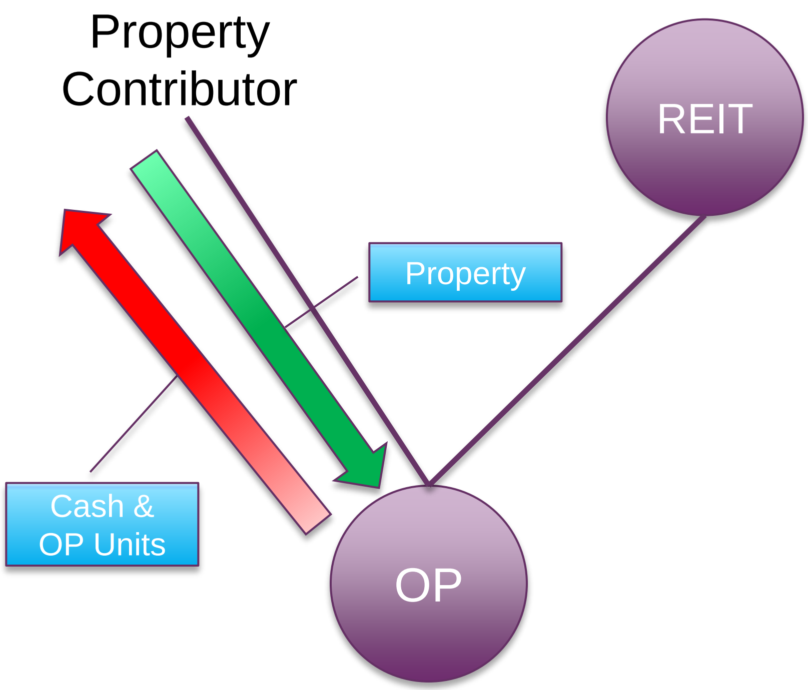
- At risk recapture.
  - Taxpayer going into negative at risk amount triggers recapture.
  - Qualified nonrecourse liabilities. Relief creating “negative basis” results in gain.
  - Relief of qualifying nonrecourse debt can create at risk recapture.

Disguised Sales and Liabilities



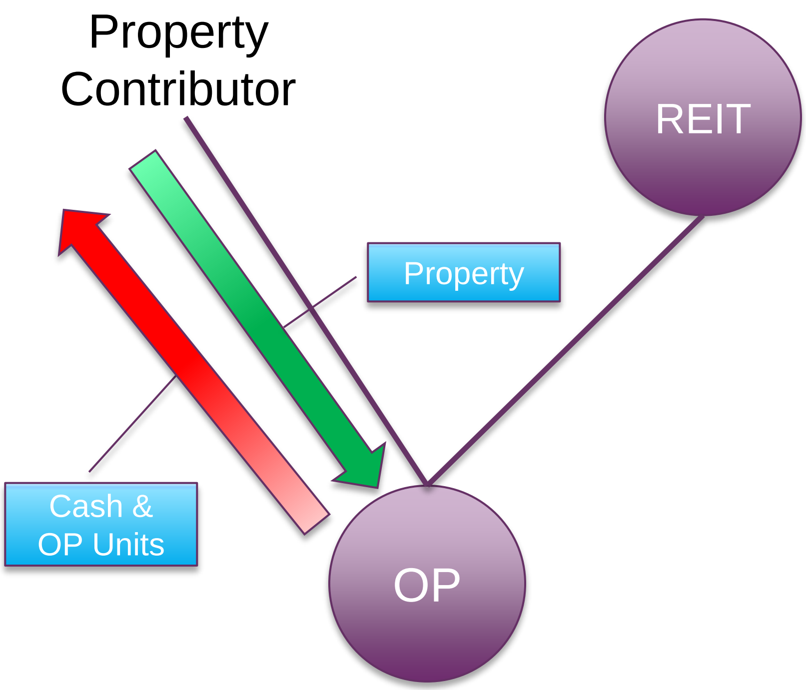
- At risk recapture.
  - Issue: is lender a “qualified person”: person actively and regularly engaged in the business of lending money.

Disguised Sales and Liabilities

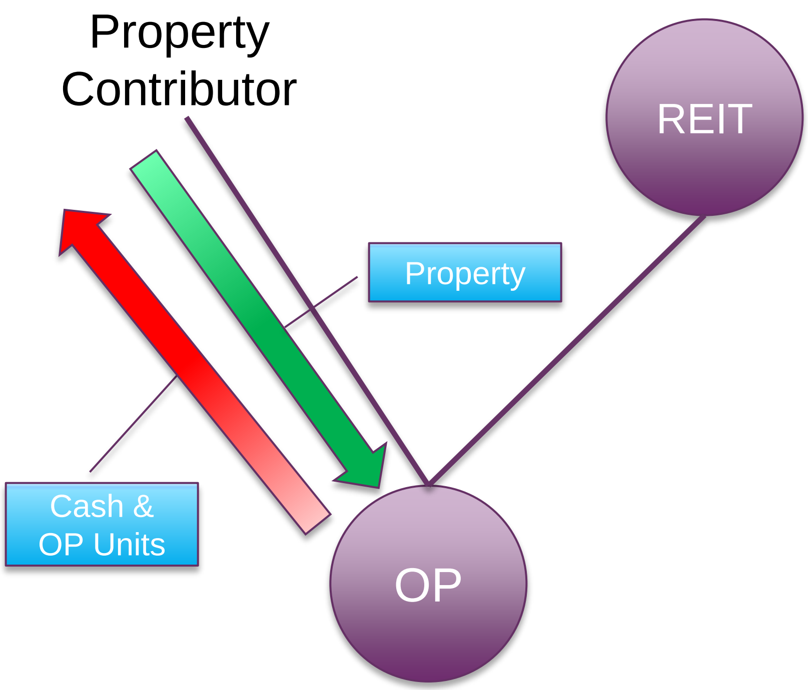


- 2 year rule.
  - Contributions subject to new liabilities (<= 2 years) can create disguised sales.
  - Distributions within two years of contribution can create disguised sales.
  - Distributions outside of two years are presumed not to be disguised sales.

Disguised Sales and Liabilities

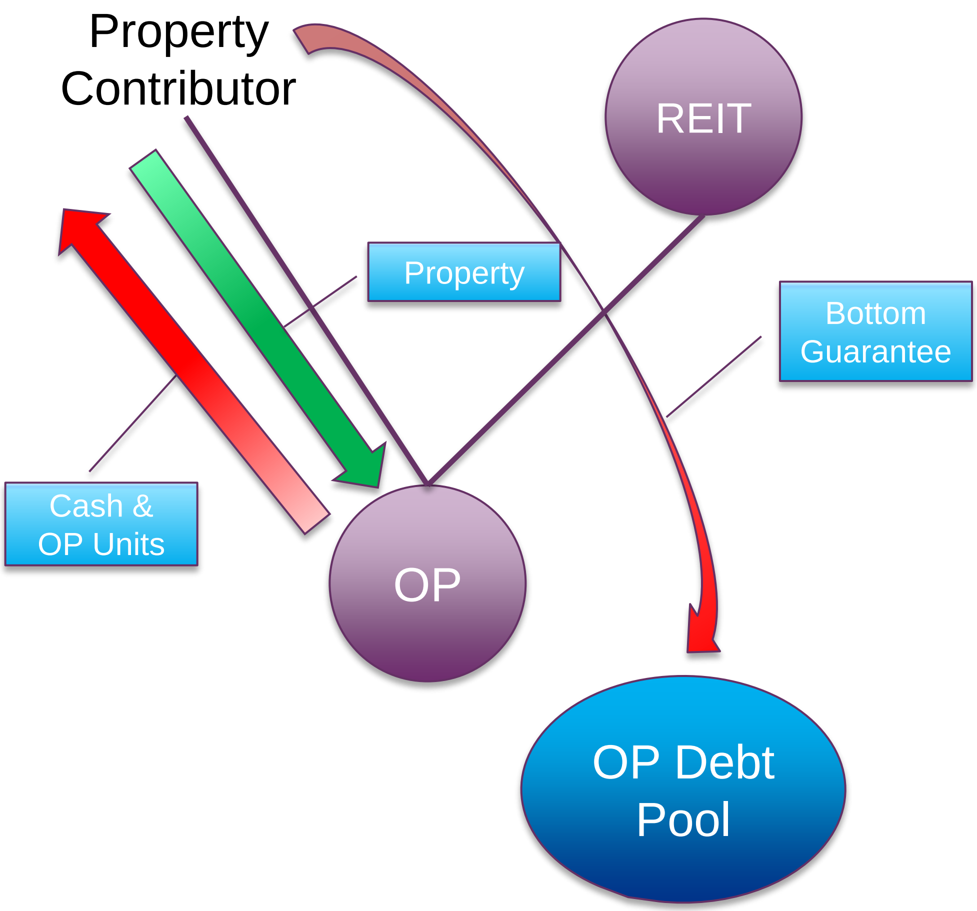


- Disguised Sale exceptions.
  - Contribution subject to qualified liabilities (> 2 yrs).
  - Reasonable preferred returns and guaranteed payments (<= 150% AFR) on unreturned capital.
  - Operating cash flow distributions: percentage of profits during year.
  - Reimbursement of preformation expenditures (<=20% FMV).



- Leveraged distributions of partner’s share of debt.

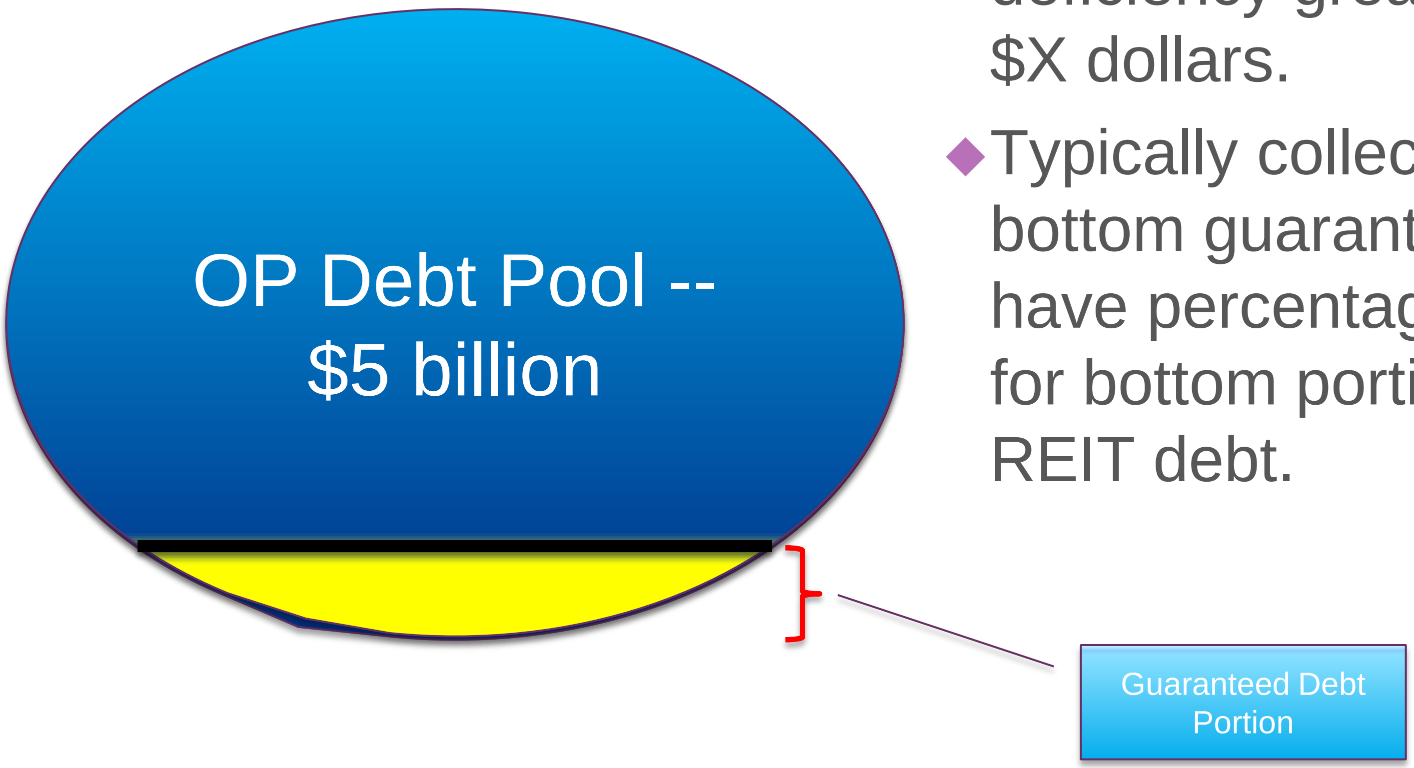
Disguised Sales and Liabilities



- Classic solution.
  - Property contributor enters into “bottom” guarantee of REIT’s pool of liabilities.

Disguised Sales and Liabilities

- Bottom Guarantee
  - Guarantee kicks in only if lender suffers deficiency greater than $X dollars.
  - Typically collection of bottom guarantors will have percentage liability for bottom portion of Up-REIT debt.



Disguised Sales and Liabilities

- *Canal Corp. v. Commissioner*, 135 T.C. 199 (2010).
  - Indemnitor was thinly capitalized subsidiary with no business operations and no real assets.
  - Treatment for accounting purposes as sale.
  - Distributed money was loaned to parent corporation.

Disguised Sales and Liabilities

- Amount distributed close to value of transferred assets.
- Lender did not ask for the indemnity.
- Indemnity covered only principal, not interest.
- Solvency of guarantor.
- Application of Section 752 antiabuse rules.

Disguised Sales and Liabilities

- Proposed Rules re Recognized Partner Payment Obligations.
  - Net value test for partners other than individuals and estates.
  - Seven recognition factors, except for state law obligations.

Disguised Sales and Liabilities

- Recognition factors:
  - Either:
    - Commercially reasonable net worth throughout the term of the payment obligation; or
    - Commercially reasonable contractual restrictions on transfers of assets for inadequate consideration.

Disguised Sales and Liabilities

- Required periodically to provide commercially reasonable documentation regarding financial condition.
- Term of guarantee >= term of the partnership liability.
- Payment obligation does not require that the primary obligor hold money or other liquid assets > reasonable needs of such obligor.

- Arm's length consideration for assuming the payment obligation.
- Guarantor liable up to the full amount of guarantor’s payment obligation to the extent of deficiency.
  - No bottom guarantees.
  - No vertical guarantees.

Disguised Sales and Liabilities

- What do we do?
  - Ensure actual net worth. How much?
  - Covenants not to reduce net worth.
    - If violated?
  - Restrict net worth depleting transfers.
    - If violated?
  - Periodic financial reports (e.g., quarterly or annual).
    - If violated?
  - Guarantee for term of loan.

Disguised Sales and Liabilities

- Bottom guarantees?
- Vertical slice guarantees?

Disguised Sales and Liabilities

- At risk?
  - Is debt qualified nonrecourse financing?
  - Are public holders treated as qualified lenders?

Disguised Sales and Liabilities

- Disguised sale exceptions.
  - Reimburse capital expenditures within two years prior to transfer.
    - 20% FMV limit.
    - Under proposed regulations, cannot double up where expenses financed.

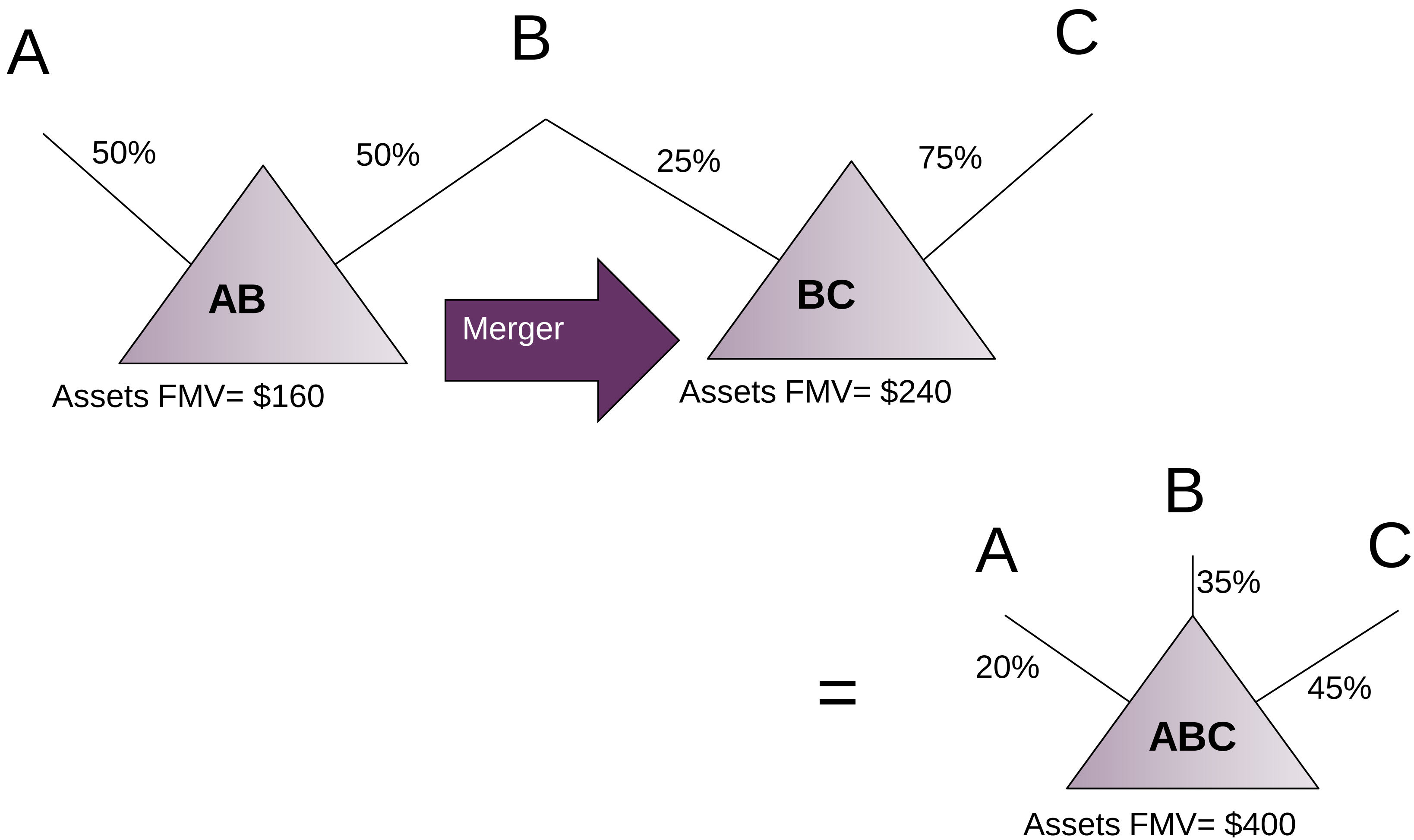
Partnership Mergers – General Rules

- A merger of one partnership into another is generally treated as a continuation of one partnership and the termination of the other merged partnership.

- ***Who Survives?*** In a merger of two or more partnerships, the resulting partnership is the continuation of any merging partnership whose members own a greater than 50% interest in the capital AND profits of the resulting partnership.
  - If the resulting partnership can be a continuation of more than one partnership, the resulting partnership is a continuation of the one credited with contributing the assets with the greatest fair market value (net of liabilities).
  - If none of the merging partnerships' members have an interest of more than 50% in the capital and profits of the resulting partnership, all merged partnerships are deemed terminated and a new partnership results.
  - New Partnerships are subject to a "new" 7-year clock under Sections 704(c)(1)(B) and 737.

Partnership Mergers – General Rules

EXAMPLE OF MERGER OF TWO OR MORE PARTNERSHIPS --



ABC is a continuation of BC

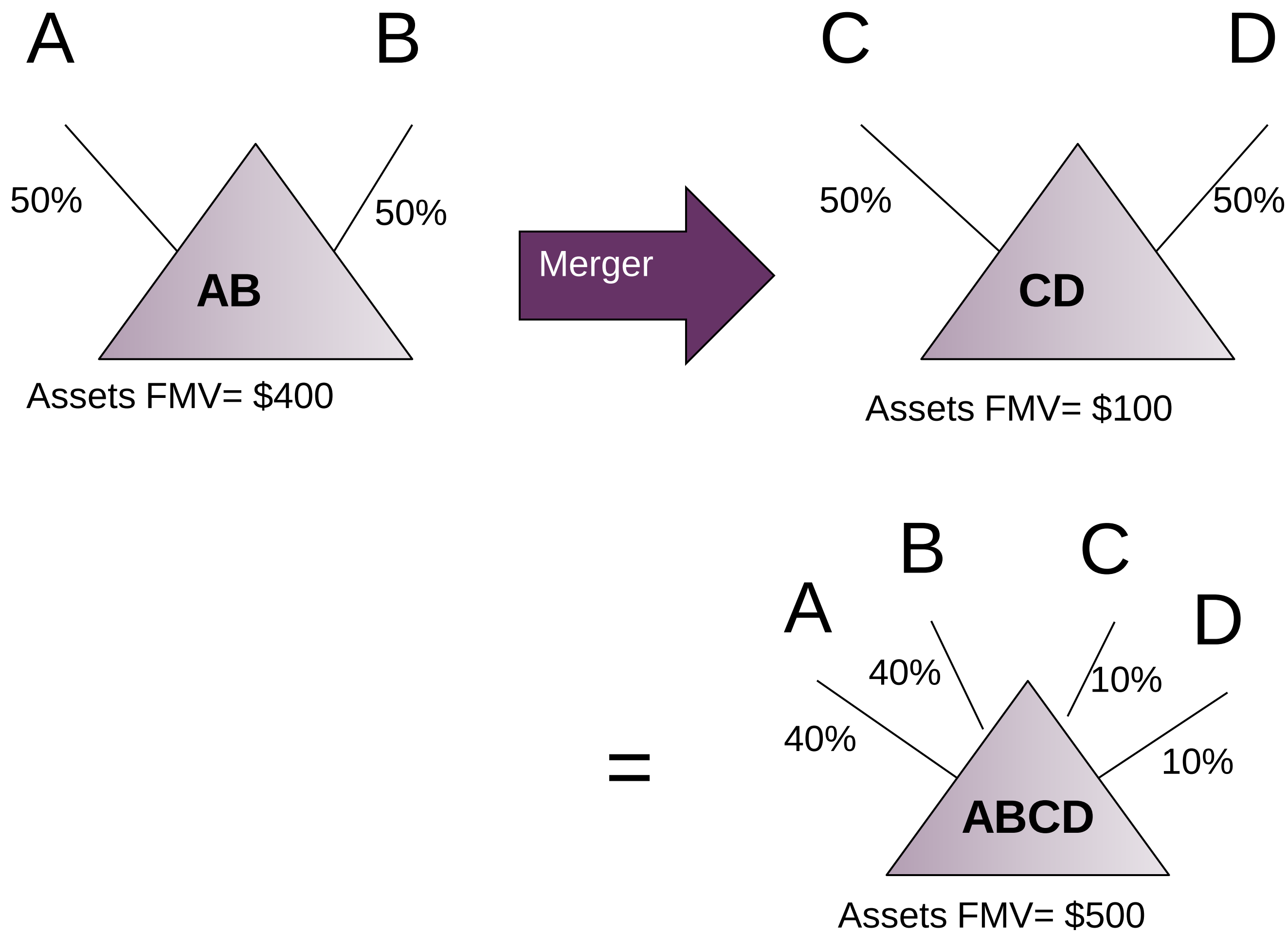
Partnership Mergers – General Rules

- **Form Does Not Override Statute** – If under applicable state law, the rules allow parties the ability to elect which entity legally survives a merger of two partnerships, the merger may be recast for U.S. federal income tax.

- *Example:* Partnership AB hold assets with a net fair market value of $400. Partnership CD holds assets with a net fair market value of $100. Both partnerships are limited liability companies of State X. Partnership AB merges into partnership CD, and under the applicable laws of State X, partnership CD is deemed to survive.
    - The merger is recast as a merger of CD into AB with the resulting partnership, ABCD, considered a continuation of partnership AB for U.S. federal income tax purposes. Partnership CD terminates.

Partnership Mergers – General Rules

EXAMPLE OF PARTNERSHIP MERGERS --

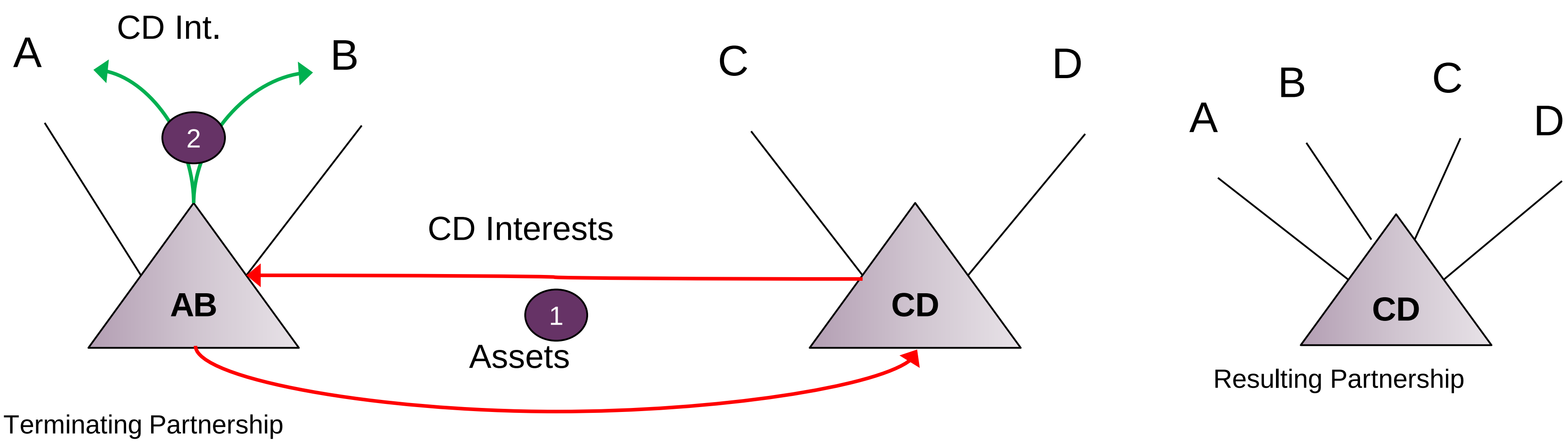


ABCD is a continuation of AB

Constructs of Partnership Mergers

- **Assets-Over Form:** The terminating partnership contributes its assets and liabilities ***over*** to the resulting partnership in exchange for an interest in the resulting partnership, and immediately thereafter, the terminating partnership distributes the interests in the resulting partnership to its partners in liquidation.

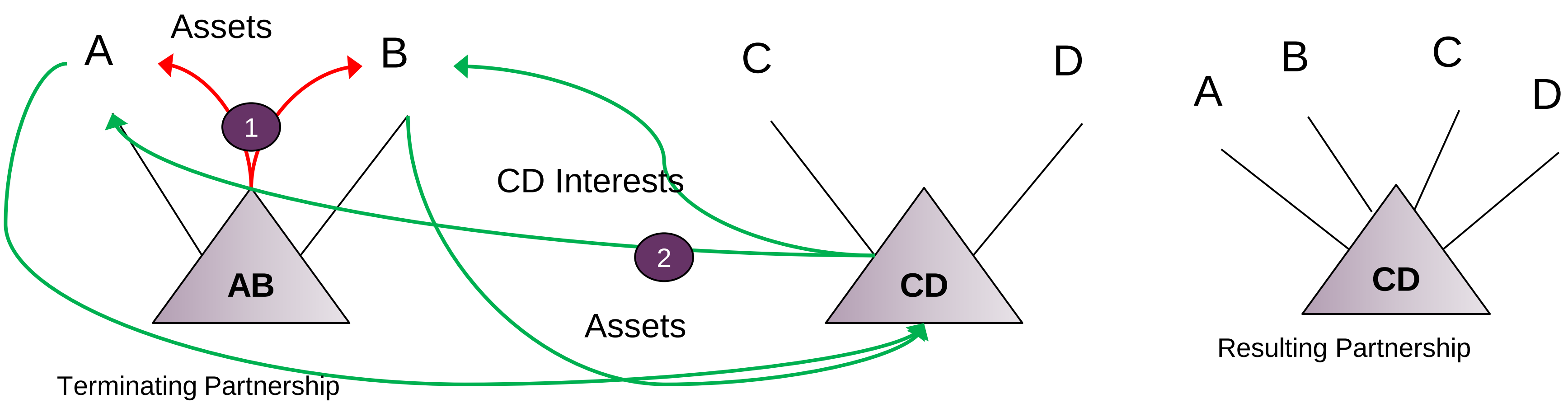
EXAMPLE OF ASSETS-OVER FORM --



Constructs of Partnership Mergers

- **Assets-Up Form:** The terminating partnership distributes all of its assets ***up*** to its partners in liquidation, and immediately thereafter, the partners of the liquidating partnership contribute the distributed assets to the resulting partnership in exchange for interests in the resulting partnership.

EXAMPLE OF ASSETS-UP FORM --



Constructs of Partnership Mergers

- **Assets-Over Form is the default construct.**
  - **No mixing:** Terminating partnerships using a combination of assets-over and assets-up will be treated as following the assets-over form.
  - **No Interest-Over Form:** Transactions where partners transfer interests in the terminating partnership in exchange for interests in the resulting partnership with the terminating partnership liquidating into the resulting partnership will be recast and characterized under the assets-over form.

Buyouts and Disguised Sales Rules

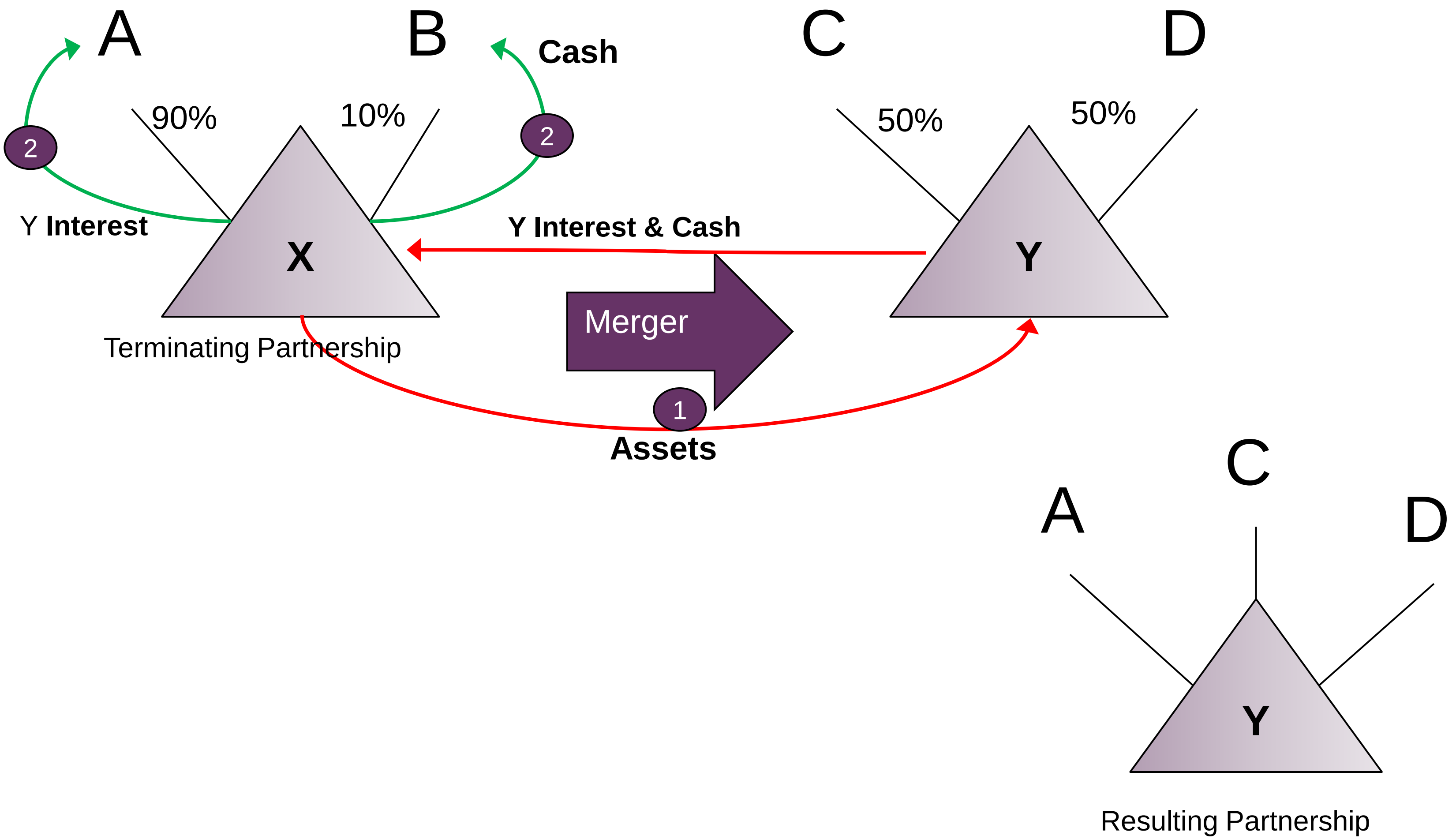
- *Example:* Partnership X and Partnership Y agree to merge via an assets-over merger with Partnership X terminating. Partner B, a 10% partner in X, does not wish to become a partner in Y and instead wants cash. Partnership X does not have sufficient cash to buyout Partner B prior to the merger.

- Normally, a transfer of assets (i.e., Partnership X assets) to partnership (Y) in exchange for partnership interests and other property could run afoul of the *disguised sale rules.* Could result in gain on the sale of assets to all terminating partners.

- The regulations permit an election to buyout dissenting partner's interest in a terminating partnership if the dissenting partner consents to treat as a sale of the partner's terminating partnership interest to the resulting partnership. **No disguised sale.**

Buyouts and Disguised Sales Rules

EXAMPLE OF BUYOUTS --



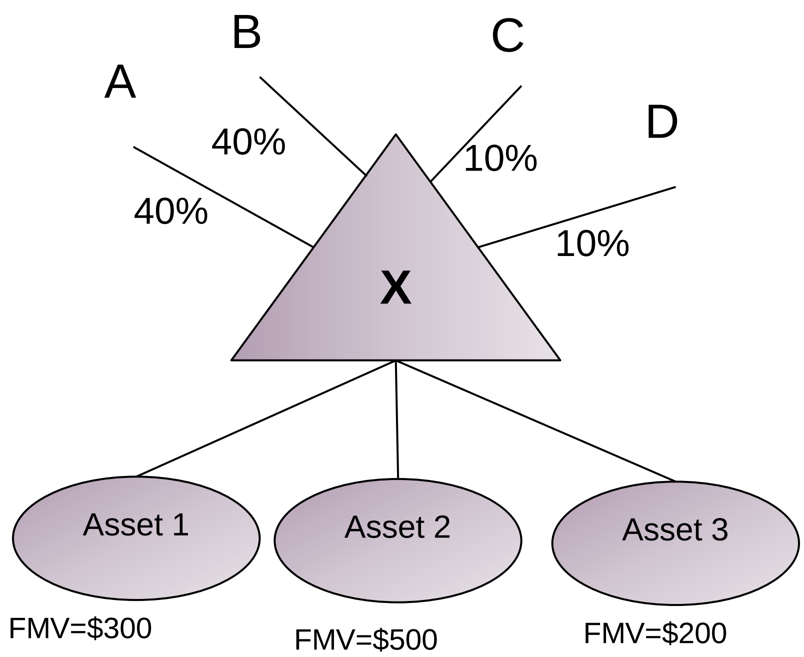
Partnership Divisions

- *General Rule* – Upon the division of a partnership into two or more partnerships, any resulting partnerships with members that had a more than 50% interest in the capital and profits of the prior partnership shall be a considered a continuation of the prior partnership.
  - If more than one resulting partnership can be considered a continuation of the prior partnership, the continuation partnership with the greatest net fair market value of assets is the *divided partnership*.
  - The *divided partnership* files as and retains attributes of prior partnership.
  - All other resulting partnerships deemed new.

- *Partnership Division Considerations –*
  - Mixing Bowl Rules…7 year period
  - Depreciation Recapture
  - Disguised Sale

Partnership Divisions

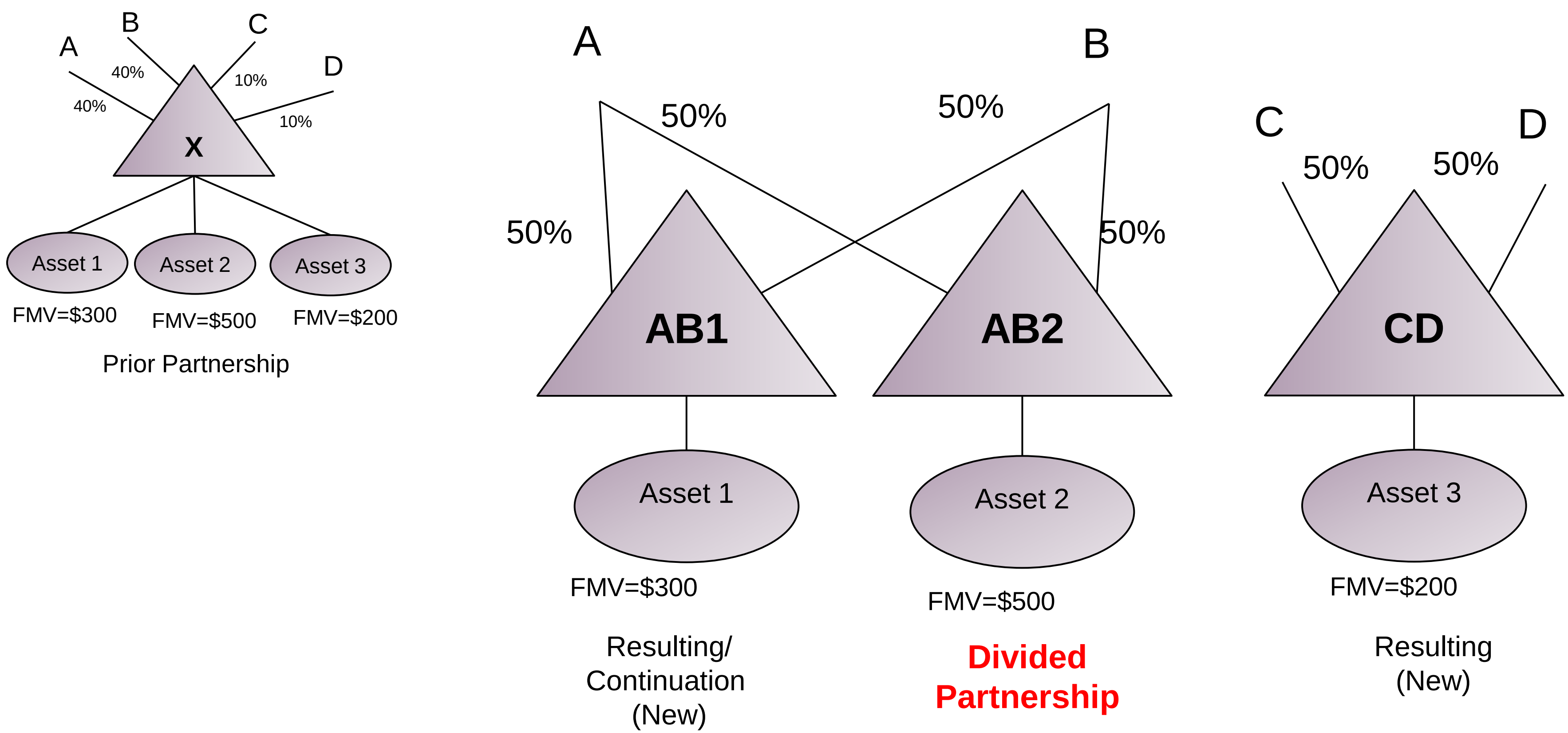
EXAMPLE OF PARTNERSHIP DIVISIONS --



Prior Partnership

Partnership Divisions

EXAMPLE OF PARTNERSHIP DIVISIONS --



LTIPs

LTIP Partnership Units

- Tax saving alternative to restricted stock available to UPREITs
- Issuance of Operating Partnership profits interest units in exchange for services
  - Subsequently booked up under IRC Section 704(b) to receive capital account and liquidity
  - May be exchanged for REIT stock after bookup and vesting
- May be issued to officers, employees and trustees and other service provider

Advantages of LTIPs

- Recipient recognizes no income on issuance or vesting
  - Withholding not required
  - No need to sell newly vested units to pay taxes
  - Avoid potential trap of ordinary income on vesting followed by capital loss on sale if stock price declines
- Gain on ultimate sale generally capital
  - Subject to IRC Section 751
  - May be considered “carried interest” under tax reform proposals

Disadvantages of LTIPs - Recipient

- Units may never be booked up
- Possible post-bookup phantom income
  - Special allocation of 704(c) gain on sales of appreciated property
- Tax return filing in multiple states
  - Composite returns can reduce required filings

Disadvantages of LTIPS - REIT

- Operating partnership ***never*** receives a deduction for issuance of LTIPs (*Rev Proc 2001-43*)
  - Restricted stock is deductible at vesting
  - Operating partnership may receive Section 754 stepup and deductions after exchange of LTIPs for REIT stock

Requirements for Profits Interest Treatment - *Rev Procs 93-27 & 2001-43*

- Units must be profits interest (*93-27*)
  - no ownership in partnership assets until bookup
- Partnership income cannot be substantially certain and predictable (*93-27*)
  - Cannot be from high-quality debt securities
  - Cannot be from high-quality net leases

Requirements for Profits Interest Treatment - *Rev Procs 93-27 & 2001-43*

- Interest must be held for at least two years (*93-27*)
- Cannot be an interest in a “publicly traded partnership” (*93-27*)
- Recipient must be treated as owner from issuance regardless of vesting (*2001-43*)
  - Must receive share of all income and other tax items
  - May receive current distributions

Non-tax Considerations

- May require Board approval or shareholder vote
- REIT can establish vesting schedule
  - Can be any combination of time and performance hurdles
- Similar GAAP treatment to restricted stock
  - Earnings upon vesting
  - May claim lesser charge if value is different from stock
- Greater administrative costs & complexity

Potential Impact of Proposed Carried Interest Legislation

- All distributions could be ordinary, earned income
- All gain on exchange of units could be ordinary, earned income
- No change with respect to tax deferral proposed to date

Examples of LTIP Tax Benefits

- 1. No change in stock price (after bookup)

		Restricted Stock			*LTIPs*		
Event	Value	Income	Cap Gain	Tax	Income	Cap Gain	Tax
Issuance	9,000	--	N/A	--	--	N/A	--
Vesting	10,000	10,000	N	5,000	--	N/A	--
Sale	10,000	--	N/A	--	10,000	Y	3,000
Total Tax				5,000			3,000
Tax Benefit		2,000					

Assumed Tax Rates: Ordinary Income – 50%; Capital Gains – 30%

Examples of LTIP Tax Benefits

- 2. Increase in stock price (after vesting)

		Restricted Stock			*LTIPs*		
Event	Value	Income	Cap Gain	Tax	Income	Cap Gain	Tax
Issuance	9,000	--	N/A	--	--	N/A	--
Vesting	10,000	10,000	N	5,000	--	N/A	--
Sale	15,000	5,000	Y	1,500	15,000	Y	4,500
Total Tax				6,500			4,500
Tax Benefit		2,000					

Examples of LTIP Tax Benefits

- 3. Decrease in stock price (after vesting)

		Restricted Stock			*LTIPs*		
Event	Value	Income	Cap Gain	Tax	Income	Cap Gain	Tax
Issuance	9,000	--	N/A	--	--	N/A	--
Vesting	10,000	10,000	N	5,000	--	N/A	--
Sale	8,000	(2,000)	Y	-- (1)	8,000	Y	2,400
Total Tax				5,000			2,400
Tax Benefit		2,600					

(1) Capital loss – limited deductibility

Example - Capital at LTIP Issuance

	Number of Shares/Units	Value per Share/Unit	704(b) Capital
Outstanding Shares/Units	50,000	30.00	1,500,000
LTIPs	1,000	30.00	--
Total Shares/Units/LTIPs	51,000		1,500,000

Example - 704(b) Gain on Bookup

704(b) Capital after Bookup	52,000 x 31.00	1,612,000
704(b) Capital before Bookup	50,000 x 30.00	1,500,000
Increase in 704(b) Capital		112,000
Less: Cash Received		-31,000
704(b) Gain		81,000

Bookup event is issuance of 1,000 shares for cash @31.00 per share

Example - Allocation of 704(b) Gain

	LTIPs	Outstanding Shares/Units
Original Capital Catchup	30,000	
Pro Rata	1,000	50,000
Total	31,000	50,000

Example - Capital after Bookup

	Number of Shares/Units	Value per Share/Unit	704(b) Gain	704(b) Capital
Outstanding Shares/Units	50,000	31.00	50,000	1,550,000
LTIPs	1,000	31.00	31,000	31,000
New Shares/Units (1)	1,000	31.00	--	31,000
Total Shares/Units/ LTIPs	52,000		81,000	1,612,000
Total 704(b) Gain				81,000

(1) Issued for Cash

Partnership Preferential Interests

Basic Forms

1. Yield on capital (i.e. straight 8% on capital)
2. Timing of distributions and return of capital
3. Pooled asset preferred
4. Catch-up or cumulative
5. Profits interest
6. Any combination of the above

Partnership Preferential Interests

Economic Considerations

1. Timing
   - Cash flow from operations
   - Cash flow from capital transactions
     - Sales and/or refinancing transactions
   - Liquidation
   - Combination of operations, capital transactions & liquidation
     - i.e. yield out of operations and return of capital out of capital events

2. Participation
   - Right to share in partnership profits
   - What's the negotiated return?

Partnership Preferential Interests

Economic Considerations (cont'd)

3. Risk
   - Will the preference be realized

All three factors impact the economics of the preference rights.

- Longer the timing…
- Greater the risk…
- Higher the return.

Common Applications

1. Cash contributors v. Asset contributors (practically either)
2. Additional capital contributions

Partnership Preferential Interests

Examples:

1. Preference solely related to **timing**
   - Partners A and B contribute $100 each
   - Year 1 partnership profits of $10
     - Partner A receives 100% of the cash flows ($10)
   - Year 2 liquidation
     - Partner A receives $95…or $105 cumulatively
     - Partner B receives $105..or $105 cumulatively

Partnership Preferential Interests

Examples:

1. Preference related to **participation**
   - Partners A and B contribute $100 each
   - Year 1 partnership profits of $10
     - Partner A receives 100% of the cash flows ($10)
   - Year 2 liquidation
     - Partner A receives $100…or $110 cumulatively
     - Partner B receives $100..or $100 cumulatively

Partnership Preferential Interests

Participation / Permanent Preference

1. Percentage of profit or percentage return
   - Fixed or variable
   - IRR or on capital with or without cumulative unpaid return
   - Non-preferred partner requirements to fund shortfall
   - Lockouts on the timing of preferred repayment
2. Repayment from operations or capital event
   - Operating = Ordinary / Sales = Capital (potentially)

Partnership Preferential Interests

Tax Distributions

1. Actual partner tax rate v. assumed tax rate
2. Cumulative income or current year income
   - Prior losses taken into account?
   - Capital call for excess distributions? (i.e. later losses)
3. Stand alone or reduction of other distributions
4. Frequency (Annual, quarterly)
5. Recoupment provisions upon liquidation

Partnership Preferential Interests

Is it really a preference?

1. Preferred Interest
   - Risk that profits are insufficient to satisfy the preference
   - Distributions not taxable with sufficient tax basis
   - Tax event upon allocation of profits (ordinary or capital)
2. Guaranteed Payment
   - Payment regardless of whether profits are adequate
   - Taxable in year the partnership deducts (receipt if capitalized)
   - Ordinary income characterization

Partnership Preferential Interests

Repayment risk? Does it make it guaranteed?

1. Preferred partner bears the risk
   - Dilutes benefit of negotiating a preferred interest
   - Satisfaction of return can't come out of other partners capital
   - At minimum, preference to receive contributed capital first
2. Non-preferred partner bears the risk
   - Capital shift satisfies the preferred return
3. Somewhere in the middle

Partnership Preferential Interests

Other items

1. Disguised sales
   - Reasonable threshold based upon “safe-harbor” rate
   - 150% of the highest Applicable Federal Rate (“AFR”)
2. Management and voting rights
   - Partner rights or lender rights

Partnership Preferential Interests

Debt v. Equity – Re-characterization Risk

1. Form and intent (IRS asserting substance over form)
2. Risk
3. Debt-to-equity ratios (thin capitalization)
4. Participation in management
5. Subordination to general creditors
6. Creditworthiness
7. Other debt-like qualities (maturity, call rights, etc.)

Partnership Preferential Interests

Debt v. Equity – Impact Analysis

1. REIT income and asset tests
   - “Self-charged” – what percentage to use
2. GAAP financial statements
   - Fee recognition
3. Debt Covenants
   - Value “credit” for loan v. equity interest

Partnership Preferential Interests

Technical 704(b) v. Economic Agreement

1. Liquidation by positive capital accounts or by distribution provisions
   - Distribution provisions preserve economic agreement
   - Capital accounts, respected, but may not reflect economics
2. Forced allocations – complex allocations following distributions
3. Curative allocations – “cures” potential distortions
4. Targeted final balance allocations – In liquidation year only