Recent Developments in Partnerships and Real Estate

Amanda F. Wilson
Lowndes, Drosdick, Doster, Kantor & Reed, P.A.

Agenda

- Proposed Partnership Audit Regulations
- Section 721(c) Regulations
- REIT Conversion Regulations
- Proposed Fractions Rule Regulations
- Proposed Management Fee Waiver Regulations
- Status of Other Significant Regulatory Projects
- Other Developments

Proposed Partnership Audit Regulations

New Proposed Partnership Audit Regulations

- REG-136118-15 was released January 18, 2017.
- The proposed regulations provide that the new centralized partnership audit regime:
  - covers any adjustment to "items of income, gain, loss, deduction, or credit of a partnership" and any partner's distributive shares of those items.
  - any Chapter 1 tax is assessed and collected at the partnership level.
  - The applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to any such item or share is determined at the partnership level.

Items of Income, Gain, Loss, Deduction or Credit

- Very broadly defined as “all items and information required to be shown, or reflected, on a return of the partnership … and any information in the partnership's books and records for the taxable year.”
- This includes:
  - character, timing, source, and amount of partnership items;
  - character, timing, and source of the partnership's activities (including passive v. active)
  - contributions and distributions;
  - partnership’s basis in its assets and value of assets;
  - amount and character of partnership liabilities;

Items of Income, Gain, Loss, Deduction or Credit

- separate category, timing, and amount of the creditable foreign tax expenditures;
- any elections by the partnership;
- items related to transactions between a partnership and any person (including disguised sales, guaranteed payments, etc.);
- any item resulting from a partnership termination or a technical termination;
- partner capital accounts, including the release of a partner from a DRO.

Electing Out of the New Audit Rules

- A partnership with <u>100 or fewer</u> eligible partners can elect out.
- 100 or fewer partners:
  - Determination of number of partners is made based on the number of statements the partnership is <u>required</u> to furnish under Section 6031(b). If partnership issues 2 statements (one for LP interest, one for GP interest), it only counts as one statement.
  - If a partnership has an S corporation partner, count the statements that the S corporation has to issue plus the statement issued to the S corporation.
  - Spouses must generally be issued two statements, unless community property state.
  - If partner dies mid-year, there are two statements. One for the individual and one for individual's estate.

Electing Out of the New Audit Rules

- An Eligible Partner is an individual, a C corporation (including RICs and REITs), an eligible foreign entity, an S corporation, or an estate of a deceased partner.
  - An eligible foreign entity is an entity treated as an association under the check the box rules.
  - An S corporation is an eligible partner regardless of whether one or more shareholders of the S corporation is not an eligible partner.

Electing Out of the New Audit Rules

- Non-eligible Partner:
  - a partnership;
  - a trust;
  - a foreign entity that is not an eligible foreign entity;
  - a disregarded entity;
  - a nominee or other similar person that holds an interest on behalf of another person; or
  - an estate of an individual other than a deceased partner.

Electing Out of the New Audit Rules

- Election is made on a timely filed partnership return (including extensions) for the partnership taxable year to which the election relates. No election can be made if the partnership return is filed late.
- The partnership must notify each of its partnerships within 30 days of making the election out.
- IRS will carefully review a partnership's decision to elect out to make sure it was permissible.

Partnership Representative

- Partnership Representative replaces the tax matters partner and is the sole person authorized to act on behalf of the partnership under the new audit rules. It does not have to be a partner.
- Designation of Partnership Representative
  - Designated on the partnership tax return for that taxable year (does not carryover to other years);
  - If designation is of an entity, the partnership must also identify and appoint an individual to act on the entity's behalf. This individual has the sole authority to act on behalf of entity partnership representative;

Partnership Representative

- Must have a substantial presence in the U.S. and capacity to act. Substantial presence requires person:
  - Able to meet with the IRS in the U.S. at a reasonable time and place;
  - Street address and telephone number in U.S.
  - U.S. tax identification number.
- No change, revocation or resignation of partnership representative until partnership (i) receives a notice of administrative proceeding for that year or (ii) files administrative adjustment request (cannot be filed solely to change partnership representative).

Partnership Representative

- If IRS determines there is not a designation in effect, it generally must notify the partnership and give it 30 days to make a designation.
  - This 30 day rule does not apply if, within 90 days, the IRS receives multiple revocations for the same tax year signed by different persons.
- If IRS designates, the designation cannot be revoked without IRS consent.
- IRS can designate any person (not limited to a partner) to be the partnership representative.

Partnership Representative

- The IRS will consider:
  - whether there is a suitable partner of the partnership (from the reviewed year or at the time of designation);
  - views of the partners having a majority interest in the partnership regarding the designation;
  - general knowledge of the person in tax matters and the administrative operation of the partnership;
  - the person's access to the books and records of the partnership;
  - whether the person is a United States person.

Authority of the Partnership Representative

"The partnership representative has the sole authority to act on behalf of the partnership for all purposes under subchapter C of chapter 63. In the case of an entity partnership representative, the designated individual has the sole authority to act on behalf of the partnership representative and the partnership. Except for a partner that is the partnership representative or the designated individual, no partner, or any other person, may participate in an examination or other proceeding involving the partnership under subchapter C of chapter 63 without the permission of the IRS. No state law, partnership agreement, or other document or agreement may limit the authority of the partnership representative or the designated individual as described in section 6223 and this section."

Prop. Reg. § 1.6223-2(c)(1).

Authority of the Partnership Representative

- No person other than the partnership representative may participate in examination or proceeding unless IRS agrees.
- Limitations on the authority of the partnership representative in partnership agreements, etc. will not prevent the action of the partnership representative from having binding effect.

Partnership Adjustments

- Default rule is that imputed underpayments with respect to any partnership adjustment are paid by the partnership.
- The payment is treated as a Section 705(a)(2)(B) expenditure (non-deductible and not properly chargeable to a capital account). Prop. Reg. §301.6241-4.
- No netting of adjustments between taxable years.
- Partnership can request a modification of an imputed underpayment received on a notice of proposed partnership adjustment. Types of modifications the IRS will consider are listed in Prop. Reg. § 1.6225-2(d).
- If adjustment does not result in an imputed underpayment, adjustment generally taken into account in the adjustment year as a reduction in non-separately stated income or as an increase in non-separately stated loss.

Push Out Elections

- Partnership representative can elect to push out one or more adjustments on a final partnership adjustment to reviewed year partners. The election is on a per adjustment basis.

- Election must be made within 45 days of mailing of the FPA. The partnership must furnish each reviewed year partner a statement showing their respective share of each partnership adjustment with respect to which the push out election is made. Cannot be included in the Schedule K-1.

- The partnership is no longer liable for the underpayment, instead the reviewed year partners become liable for the tax, penalties, and interest on their share of the partnership adjustments.

Push Out Elections

- Each reviewed year partner has to pay the aggregate of the adjustment amounts (determined under Prop. Reg. § 301.6226-3(b)) or the safe harbor amount (determined in accordance with Prop. Reg. § 301.6226-2(g)).
- The aggregate of the adjustment amounts is the aggregate of the correction amounts for the first affected year and for the intervening years.
- The amount for each year is determined separately.
- Adjustments to tax attributes are taken into account.
- Any decreases in chapter 1 tax that would result from the adjustments are not taken into account when calculating the correction amounts.

Reserved Issues

- Application of push out election when one of the reviewed year partners is a partnership.
  - Technical correction bill introduced last year would have allowed partnership or S corporation to either pay or push out the underpayment.
- Whether there should be an adjustment to tax attributes affected by a partnership adjustment.
  - Section 6226 only provides for adjustment for purposes of calculating correction amounts.
  - Preamble indicates that partners’ outside bases, capital accounts and partnership’s basis and book value for property should be adjusted, but proposed regulations reserve on this issue.

Other Topics Addressed In Regulations

- Administrative adjustment request procedures;
- Partnerships that cease to exist.

Section 721(c) Regulations

New Section 721(c) Regulations

- On January 18, 2017, the IRS released final and temporary (T.D. 9814) and proposed (REG-127203-15) regulations under Section 721(c) addressing cross-border partnership transfers.

- IRS first announced intent to address these situations in Notice 2015-54 (August 6, 2015).

- Section 721(c) provides that "The Secretary may provide by regulations that subsection (a) shall not apply to gain realized on the transfer of property to a partnership if such gain, when recognized, will be includible in the gross income of a person other than a United States person."

- These regulations apply Section 721(c) to override the general non-recognition rule of Section 721(a) where Section 721(c) property is contributed to a Section 721(c) partnership unless the partnership adopts the remedial method and satisfies certain other requirements.

New Section 721(c) Regulations

- Section 721(c) Property is "property, other than excluded property, with built-in gain that is contributed to a partnership by a U.S. transferor."
- Excluded Property is
  - cash equivalent,
  - securities within the meaning of Section 475(c)(2),
  - tangible property with a book value exceeding adjusted tax basis by no more than $20,000 or with an adjusted tax basis in excess of book value, and
  - an interest in a partnership in which 90% or more of the property consists of items listed above.

New Section 721(c) Regulations

- Section 721(c) Partnership is a partnership (domestic or foreign) if
  - a U.S. transferor contributes Section 721(c) property,
  - a related foreign person is a direct or indirect partner; and
  - the U.S. transferor and related persons own 80 percent or more of the interests in partnership capital, profits, deductions, or losses
- This is an increase from the 50% threshold in the notice.

General Override of Section 721(a)

- General rule: Section 721(a) will not apply to gain realized by the contributing partner upon a contribution of Section 721(c) Property to a Section 721(c) Partnership.

- Exceptions:

  – a direct contribution by a U.S. transferor if the U.S. transferor and related persons do not own 80 percent or more of the interests in partnership capital, profits, deductions, or losses.

  – contributions where the sum of the built-in gain with respect to all Section 721(c) property contributed in that taxable year does not exceed $1 million.

Partnership Look-Through Rule

- Partnership look-through rule:
  - If a U.S. transferor is a direct or indirect partner in a partnership (upper-tier partnership) and the upper-tier partnership contributes all or a portion of its property to another partnership (lower-tier partnership), then, for purposes of determining if the lower-tier partnership is a Section 721(c) partnership, the U.S. transferor is treated as contributing to the lower-tier partnership its share of the property actually contributed by the upper-tier partnership to the lower-tier partnership.
  - Does not apply to deemed contributions from technical terminations.

Gain Deferral Method

- The recognition of gain on a contribution of Section 721(c) Property to a Section 721(c) Partnership can be avoided if the partnership satisfies the following requirements of the gain deferral method:
  - The partnership either
    - Uses remedial allocation method with respect to the Section 721(c) Property and for all taxable years allocates each book item of income, gain, deduction and loss with respect to that property to the U.S. transferor in the same percentage; or
    - The distributive share of all items for the Section 721(c) property allocated to foreign related partners (direct and indirect) are taxed as effectively connected income;

Gain Deferral Method

- Upon acceleration event, the U.S. transferor recognizes remaining built-in gain for the Section 721(c) property;
- Procedural and reporting requirements satisfied;
- U.S. transferor extends the statute of limitations (e.g., up to 8 years following the gain deferral contribution); and
- Tiered partnership rules applied in certain circumstances.

Acceleration Events

- Acceleration event is any event that either would reduce the amount of remaining built-in gain that a U.S. transferor would recognize under the gain deferral method if the event had not occurred or could defer the recognition of the remaining built-in gain.
- Applied on a property-by-property basis and includes:
  - contribution of Section 721(c) Property to another partnership by a Section 721(c) Partnership and a contribution of an interest in a Section 721(c) Partnership to another partnership;
  - failure to comply with gain deferral method requirements.

Acceleration Events

- Consequence is U.S. transferor must recognize gain in an amount equal to the remaining built-in gain if the partnership had sold the property for FMV.
- The regulations identifies several acceleration event exceptions, which include events such as:
  - Section 351 transfer of Section 721(c) Property (other than a partnership interest) to a domestic corporation;
  - incorporation of a Section 721(c) Partnership into a domestic corporation; and
  - Section 721(c) Partnership ceases to have a foreign related partner.

Section 197(f)(9)

- The regulations also address how the remedial allocation method should be applied with respect to Section 197(f)(9) intangible property. Treas. Reg. §1.704-3T(d)(5)(iii).
- The partnership has to amortize the amount by which its book value in the intangible exceeds its adjusted tax basis.
- To the extent that the ceiling rule would prohibit the allocation of book amortization to a noncontributing related partner, instead of creating a remedial item of deduction for the related partner to offset a remedial item of income for the contributing partner, there is a basis increase in the partnership's adjusted basis in the intangible solely with respect to the related partner. This adjustment is taken into account for determining the related partner's share of gain on a sale of the intangible but is eliminated if the related person transfers its partnership interest.

Effective Date

- Temporary regulations have an immediate effective date, subject to certain provisions being applied retroactively to the date of the Notice.

REIT Conversion Regulations

REIT Conversion Regulations

- Treas. Reg. § 1.337(d)-7(a) (1) provides that, if the property of a C corporation becomes the property of a RIC or REIT through a conversion transaction (i.e., by transfer of the property or by the C corporation electing REIT or RIC status), then Section 1374 treatment will apply unless the C corporation elects deemed sale treatment.
- Section 1374 requires S corporations to recognize a corporate level tax on built-in gains in the corporation at the time of the S election if the property is disposed of within the recognition period.
- Treas. Reg. § 1.337(d)-7(b) sets forth the rules for how Section 1374 should be applied to REITS and RICs.

REIT Conversion Regulations

- The Protecting Americans Against Tax Hikes Act of 2015 ("PATH Act") amended Section 1374(d)(7) to reduce the built-in gain recognition period for S corporations from 10 years to 5 years.
- On June 8, 2016, Proposed and Temporary Regulations were issued providing that, for purposes of applying Section 1374 treatment under Treas. Reg. § 1.337(d)-7(b) to RICs and REITs, the recognition period is a <u>10 year period</u> starting on the first day of the RIC or REIT's first taxable year or the day the property is acquired (for transfers of property).
- On October 18, 2016, the Chairmen and Ranking Members of the House Ways and Means Committee and the Senate Finance Committee sent a letter to the Treasury Secretary saying that this recognition period was inconsistent with congressional intent and the longstanding practice of RICs, REITs, and S corporations having the same recognition period.

Final REIT Recognition Period Regulations

- On January 18, 2017, the final regulations were issued that adopted the Section 1374 recognition period (i.e., 5 year recognition period):

  > "For purposes of applying the rules of section 1374 and the regulations thereunder, as modified by paragraph (b) of this section, the term recognition period means the recognition period described in section 1374(d)(7)…."   Treas. Reg. § 1.337(d)-7(b)(2)(iii).

- This change will go into effect February 17, 2017, but taxpayers may affirmatively apply this provision for conversion transactions that occurred on or after August 8, 2106.

Section 355 Distributions Involving REITS

- The PATH Act also contained provisions that
  - Section 355 treatment does not apply to a distribution if either the distributing or the controlled corporation is a REIT (except in certain cases where the REIT is distributing stock of another REIT or a TRS).
  - A corporation cannot elect REIT status during the 10 year period following a Section 355 distribution if the corporation was the distributing corporation or the controlled corporation. Section 856(c)(8).
- These provisions apply to distributions on or after December 7, 2015 (except in certain instances where a PLR was already in process).
- The June 8, 2016 Temporary and Proposed Regulations otherwise still remain in effect. These address concerns that affiliated corporations could be used to circumvent PATH Act changes.

Temporary and Proposed REIT Regulations

- Conversion Following Spin-off. If a REIT is party to a Section 355 distribution within the 10 year period following a conversion transaction, the REIT recognizes any remaining unrecognized built-in gains and losses from the conversion transaction (taking into account any built-in gains and losses recognized since the conversion). Temp. Treas. Reg. § 1.337(d)-7(b)(4).

- Spin-off Following Conversion. If there is a conversion transaction within the 10 year period following a Section 355 distribution, the C corporation is deemed to have sold all of the converted property for fair market value. Temp. Treas. Reg. § 1.337(d)-7(b)(6).

- Applies to Section 355 distributions where the C corporation or the REIT engaging in the Section 355 distribution is the distributing or controlled corporation or is a member of the separate affiliated group of the distributing or controlled corporation.

Temporary and Proposed REIT Regulations

- These rules do not apply if:
  - Both the distributing and controlled corporation in the Section 355 distribution are REITs immediately after the date of the distribution and for the next 2 years.
  - The distributing corporation is a REIT and the controlled corporation is a TRS.
  - Distributions in certain circumstances where PLR request was submitted on or before December 7, 2015.

Proposed Fractions Rule Regulations

Proposed Regulations

- Section 514 treats as unrelated business taxable income from debt-financed property (i.e. property with acquisition indebtedness).
- Section 514(c)(9)(A) provides an exception to this rule in the case of qualified organizations that incur acquisition indebtedness to acquire or improve real property. Where the real property is held through a partnership, the partnership must be fractions rule compliant.
- On November 23, 2016, IRS issued proposed regulations applying the fractions rule to partnerships. REG-136978-12.

General Fractions Rule

A partnership meets the requirements of this subparagraph if—

1. the allocation of items to any partner which is a qualified organization cannot result in such partner having a share of the overall partnership income for any taxable year greater than such partner's share of the overall partnership loss for the taxable year for which such partner's loss share will be the smallest, and

2. each allocation with respect to the partnership has substantial economic effect within the meaning of Section 704(b)(2).

Section 514(c)(9)(E).

Chargebacks and Preferred Returns

- Chargebacks
  - Except as provided in regulations, a partnership may without violating the requirements of this subparagraph provide for chargebacks with respect to disproportionate losses previously allocated to qualified organizations and disproportionate income previously allocated to other partners. Any chargeback referred to in the preceding sentence shall not be at a ratio in excess of the ratio under which the loss or income (as the case may be) was allocated. Section 514(c)(9)(E)(ii)(I).
- Preferred Returns
  - To the extent provided in regulations, a partnership may without violating the requirements of this subparagraph provide for reasonable preferred returns or reasonable guaranteed payments. Section 514(c)(9)(E)(ii)(II).

Preferred Returns

- Treas. Reg. § 1.514(c)-2(d) currently disregards, in computing overall partnership income for fractions rule purposes, income and gain allocated to a partner for a reasonable preferred return.
- This is limited, though, to current distributions and does not address accrued but undistributed preferred returns.
- The proposed regulations get rid of the current distribution requirement provided (i) the partnership agreement requires the preferred return must be distributed prior to any other distributions (except tax distributions, and (ii) any accrued but unpaid preferred return compounds.

Partner-Specific Expenditures and Management Fees

- Treas. Reg. § 1.514(c)-2(f) provides that certain partner-specific expenditures are disregarded when doing fractions rule determinations.
- The proposed regulations add management and similar fees to this list to the extent they do not exceed 2% of the partner's aggregate committed capital.
- Potential impact of the new partnership audit rules. Comments are requested as to whether imputed underpayments should also be added to this list of partner specific expenditures.

Unlikely Losses

- Treas. Reg. § 1.514(c)-2(g) disregards unlikely losses or deductions (other than nonrecourse deductions) that are specially allocated to a partner.
- Current standard is that the loss or deduction must have a “low likelihood” of occurring, taking into account all relevant facts, circumstances, and information available to the partners (including bona fide financial projections).
- Consideration is being given to using a “more likely than not” standard, and comments are requested on this or another appropriate standard.

Chargebacks

- Because partner-specific expenditures and unlikely losses are disregarded for fraction rule purposes, allocations to reverse out these items could result in a fractions rule violation.
- Treas. Reg. § 1.514(c)-2(e)(1) allows for chargebacks, but only if the chargeback is pro rata portion of each item of partnership income, gain, loss and deduction that is included in computing overall partnership income or loss.
- The proposed regulations allow an allocation of net income to reverse special allocations of unlikely losses or partner-specific items.

Subsequent Acquisitions of Partnership Interests

- The proposed regulations allow for changes in partnership interests as a result of staged closings without triggering “close scrutiny.”
- To qualify:
  - — the new partner acquires the partnership interest no later than 18 months following the formation of the partnership;
  - — 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;

Subsequent Acquisitions of Partnership Interests

— 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

— the interest rate for any applicable interest 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 was formed.

Other Changes

- Capital Commitment Defaults/Contribution Reductions
- Tiered Partnerships
- De Minimis Exception

Management Fee Waiver Proposed Regulations

Proposed Regulations

- IRS issued proposed regulations under Section 707(a)(2)(A) on July 23, 2015.
- An arrangement will be treated as a disguised payment for services if
  - A person (service provider), either in a partner capacity or in anticipation of becoming a partner, performs services (directly or through its delegate) to or for the benefit of a partnership;
  - There is a related direct or indirect allocation and distribution to such service provider; and
  - The performance of such services and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a person acting other than in that person's capacity as a partner.

Relevant Factors

- Non-exclusive list of factors considered when determining whether an arrangement constitutes a payment for services:
  - The arrangement lacks significant entrepreneurial risk. This is the primary factor. There is a presumption that arrangement lacks significant entrepreneurial risk if:
    - Capped allocations of partnership income if the cap is reasonably expected to apply in most years;
    - An allocation for one or more years under which the service provider's share of income is reasonably certain;
    - An allocation of gross income;

Relevant Factors Continued

- An allocation (under a formula or otherwise) that is predominantly fixed in amount, is reasonably determinable under all the facts and circumstances, or is designed to assure that sufficient net profits are highly likely to be available to make the allocation to the service provider (e.g. if the partnership agreement provides for an allocation of net profits from specific transactions or accounting periods and this allocation does not depend on the long-term future success of the enterprise); or

- An arrangement in which a service provider waives its right to receive payment for the future performance of services in a manner that is non-binding or fails to timely notify the partnership and its partners of the waiver and its terms.

– The service provider holds, or is expected to hold, a transitory partnership interest or a partnership interest for only a short duration

Relevant Factors Continued

- The service provider receives an allocation and distribution in a time frame comparable to the time frame that a non-partner service provider would typically receive payment.
- The service provider became a partner primarily to obtain tax benefits that would not have been available if the services were rendered to the partnership in a third party capacity.
- The value of the service provider's interest in general and continuing partnership profits is small in relation to the allocation and distribution.
- The arrangement provides for different allocations or distributions with respect to different services received, the services are provided either by one person or by persons that are related under Sections 707(b) or 267(b), and the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly.

Other Significant Regulatory Projects

Significant Regulatory Projects

Status update

- Guidance on targeted capital accounts
- Regulations under Sections 761 and 1234 regarding tax treatment of noncompensatory partnership options
- Others

Other Developments

Other Developments

PLR 201644018 (October 28, 2016 – Corporate)

- One of the issues addressed is the debt of a single member disregarded LLC.
- IRS concluded that "[u]nder state law limitations on liability, [parent] is not personally liable on any portion of the [disregarded entity's] debt, and such debt will be treated as nonrecourse liabilities of [parent].
- As a result, gain from cancelling the debt was realized under Section 1001, not Section 61(a)(12) COD income, and Section 108 bankruptcy exclusion was not applicable.