Hot Topics: Real Estate and Partnerships

Fall 2019 ABA Meeting
San Francisco, CA

Moderator:
Monisha Santamaria, Ernst & Young LLP, Los Angeles, CA

Panelists:
Nickolas Gianou, Skadden, Arps, Slate, Meagher & Flom LLP, Chicago, IL
Kathy Reed, Branch Chief, Branch 7, Income Tax & Accounting, IRS, Washington, DC
Agenda

- Bonus Depreciation (Section 168(k))
- Carried Interests (Section 1061)
- Opportunity Zones (Sections 1400Z–1 and 1400Z–2)
- Business Interest Deduction (Section 163(j))
- Qualified Foreign Pension Funds (Section 897(l))
- Disguised Sales (Section 707)
- Partnership Liabilities (Section 752)
- Other Priority Guidance Plan Items
Disclaimer

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Bonus Depreciation: Section 168(k)
Section 168(k): Overview

- Section 168(k) allows for 100% bonus depreciation for certain property acquired and placed in service after September 27, 2017 and before January 1, 2023 (the percentage scales down thereafter)
- To be eligible for bonus depreciation, the property:
  - (1) must be “qualified property;” and
  - (2) either (a) the original use must begin with the taxpayer, or (b) the acquisition of such property meets the “acquisition requirements” of Section 168(k)(2)(E)(ii)
    - Thus, used property is eligible for bonus depreciation
- Section 168(k)(7) allows a taxpayer to elect out of bonus depreciation for any class of property for any tax year
- Guidance
  - Proposed regulations under Section 168(k) published on August 8, 2018
  - Final regulations under Section 168(k) currently at OIRA
    - Substance?
    - Timing?
Section 168(k): Key Issues with Respect to Partnership Transactions

• Used property may be eligible for bonus depreciation; application to key partnership transaction unclear under the statute

• Section 743(b) Basis Adjustments
  ➢ The proposed regulations may allow bonus depreciation with respect to a Section 743(b) basis adjustment

  ➢ Key Requirement under the proposed regulations: Prior to the purchase, the transferee never had a depreciable interest in the portion of the property to which the Section 743(b) basis adjustment relates

  ➢ The proposed regulations allow for the “decoupling” of an election out under Section 168(k)(7)

    ➢ Even if the partnership made the election under Section 168(k)(7) not to claim bonus depreciation for all other qualified property of the partnership in the same class of property as the Section 743(b) adjusted property, the partner may be allowed bonus recovery on the Section 743(b) basis adjustment

• Rev. Rul. 99-5 Transactions
  ➢ The proposed regulations may allow bonus depreciation following a Rev. Rul. 99-5 transaction

    ➢ If bonus depreciation is available, entire benefit accrues to the purchaser
Section 168(k): Key Issues with Respect to Partnership Transactions (cont.)

- **Remedial Allocations**
  - The proposed regulations provide that remedial allocations under Section 704(c) with respect to contributed property and with respect to property that has been revalued for Section 704(b) purposes (i.e., reverse Section 704(c) allocations) do **not** satisfy the used property requirements, precluding application of the first-year bonus recovery period.

- **Basis Increases under Section 732**
  - The proposed regulations provide that any portion of the basis of distributed property determined under Section 732 does **not** satisfy the used property requirements, precluding application of the first-year bonus recovery period.

- **Section 734(b) Basis Adjustments**
  - The proposed regulations provide that any increase to the basis of depreciable property under Section 734(b) does **not** satisfy the used property requirements, precluding application of the first-year bonus recovery period.

- **Disguised Sales**
  - The proposed regulations **do not address** Section 707 disguised sales.

- **Rev. Rul. 99-6 Transactions**
  - The proposed regulations **do not address** Rev. Rul. 99-6 transactions.
Section 168(k): Qualified Improvement Property (QIP)

- TCJA drafting error that left certain property meeting the QIP definition ineligible for bonus depreciation
  
  ➢ The TCJA eliminated the qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property asset classifications from Section 168 for property placed in service after December 31, 2017
  
  ➢ While the TCJA retained the definition of QIP, it specifically removed QIP from the list of qualified property and failed to provide it with a 15-year recovery period, thereby making QIP ineligible for bonus depreciation going forward

- The proposed regulations confirmed that QIP acquired after September 27, 2017, and placed in service before January 1, 2018, is eligible for 100% bonus depreciation

- The IRS and Treasury have previously stated they do not have the authority to fix the TCJA drafting error through regulations or other IRS guidance

- Identified as an issue for technical corrections
Carried Interests:
Section 1061
Carried Interest: Overview

• Section 1061 converts net long-term capital gain with respect to an applicable partnership interest (API) to short-term capital gain to the extent the gain would not qualify as net long-term capital gain if "1 year" is changed to "3 years" in Section 1222(3) and (4), notwithstanding Section 83 or any election in effect under Section 83(b)

  ➢ API: Any activity conducted on a regular, continuous and substantial basis that, regardless of whether the activity is conducted in one or more entities, consists, in whole or in part, of:
    ➢ Raising or returning capital, and
    ➢ Either (1) investing in (or disposing of) "specified assets" (or identifying specified assets for such investing or disposition) or (2) developing specified assets

  ➢ Specified assets: Securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivatives contracts with respect to any of the foregoing, and an interest in a partnership to the extent of the partnership's proportionate interest in any of the foregoing

• Amount treated as short-term capital gain is the excess of: (1) the taxpayer's net long-term capital gain with respect to the API for the taxable year over (2) the taxpayer's net long-term capital gain with respect to the API for the taxable year computed by applying paragraphs (3) and (4) of Section 1222 by substituting "three years" for "one year"
Carried Interest: Guidance to Come

• No guidance to date; regulations on priority guidance plan
  ➢ Will guidance address:
    ➢ Section 1061’s application to Section 1231 gains;
    ➢ Section 1061(b)’s exception for gains on portfolio investments;
    ➢ Section 1061(d)’s anti-abuse rule;
    ➢ Section 1061’s application if the API is held for more than three years but the sold partnerships assets are held for less than three years; and/or
    ➢ Section 1061’s application if the sold partnership assets are held for more than three years but the API is held for less than three years?
  ➢ Timing?
Opportunity Zones: Sections 1400Z–1 and 1400Z–2
Opportunity Zone Regime: Overview

- Under Sections 1400Z-1 and 1400Z-2, taxpayers can defer capital gain from the sale or exchange of property by reinvesting into certain low-income communities that have been specially designated as “qualified opportunity zones”
  - Cash up to the amount of capital gain on such sale can be rolled over into an “opportunity zone fund” within the 180-day period beginning on the date the gain would otherwise be recognized

- Key Tax Benefits
  - Eligible gains are deferred until the earlier of:
    - The sale or exchange of the interest in the opportunity zone fund; or
    - December 31, 2026
  - Recognized gain is reduced by up to 15% depending on how long the opportunity zone fund investment is held:
    - Deferred gain is reduced by 10% after 5 years (must invest before 2022)
    - Deferred gain is reduced by another 5% (for a total of 15%) after 7 years (must invest before 2020)
  - There is a permanent tax exemption for gain on the disposition of an opportunity zone fund interest held for more than 10 years and sold before 2048 (the 10-year tax exemption)
Opportunity Zone Regime: Guidance

- The statutory language of Sections 1400Z-1 and 1400Z-2 left open a number of ambiguities and uncertainties, making regulatory guidance necessary
- A set of proposed regulations was published on October 29, 2018 (and Rev. Rul. 2018-29 was published on November 5, 2018)
  - The 2018 guidance addressed a number of key issues relating to real estate investments, including:
    - Clarification of ability to roll over gains recognized through pass-through entities/timing of 180-day rollover period;
    - Clarification of “substantial improvement” requirement for land/buildings; and
    - The working capital safe harbor
  - But the 2018 guidance left many other key issues unresolved, including the application of 10-year tax exemption to direct or indirect sales of property by an opportunity zone fund; the interaction with subchapter K (e.g., leveraged distributions, cost recovery); and the treatment of leased property
A second set of proposed regulations was published on May 1, 2019

- The May 2019 regulations addressed many, but not all, of the key remaining issues, including a number relevant to real estate investments, such as:
  - The treatment of leverage and leveraged distributions;
    - Subchapter K basis principles generally apply (Section 752 debt allocation result in outside basis)
    - Leveraged distributions generally permitted after two years
  - The applicability of 10-year tax exemption to asset sales;
  - Exemption applies to certain asset sales, but certain drafting ambiguities remain
  - The treatment of leased property;
    - OZ funds and QOZBs generally can lease OZ property, subject to certain additional requirements
    - The application of “trade or business” requirements to real estate leasing activities

Finalization of the proposed regulations and future guidance expected

- Substance?
- Timing?
Business Interest Deduction: Section 163(j)
Section 163(j): Overview

• Generally, Section 163(j) limits the deduction for business interest expense (BIE) for the taxable year to the sum of:
  ➢ 30% of the taxpayer’s adjusted taxable income (ATI) for such taxable year,
  ➢ Business interest income (BII) of such taxpayer for such taxable year, plus
  ➢ Floor plan financing interest of such taxpayer for such taxable year
• Any amount disallowed under Section 163(j) is carried forward and generally treated as business interest paid or accrued in the succeeding taxable year
• Section 163(j) applies at the entity level, with special rules for partnerships and S corporations
• Certain exceptions and exclusions
• Guidance
  ➢ Proposed regulations under Section 163(j) published on December 28, 2018
  ➢ Final regulations on priority guidance plan
    ➢ Substance?
    ➢ Timing?
Section 163(j): Key Partnership Issues

- 11 Steps
  - The proposed regulations contain an 11-step process for determining the extent to which a partner's distributive share of partnership items consist of (1) deductible BIE; (2) excess business interest expense (EBIE); (3) excess taxable income (ETI); and (4) excess business interest income (EBII)
  - Mechanical and complex

- Guaranteed Payments
  - The proposed regulations treat guaranteed payments for capital as interest
  - May allow a partner to increase its Section 163(j) limitation

- -10 Allocation Rules
  - The proposed regulations provide rules for allocating tax items, including BIE and BII, between excepted trades or businesses and non-excepted trades or businesses; BIE and BII are allocated among excepted and non-excepted trades or businesses based upon the relative amounts of the taxpayer's adjusted tax basis in the assets used in those trades or businesses

- Tiered Partnerships
  - The proposed regulations reserved on the issue

- Mergers and Divisions
  - The proposed regulations reserved on the issue

- Self-Charged Interests
  - The proposed regulations reserved on the issue

- Debt-Financed Acquisitions and Debt-Financed Distributions
  - The proposed regulations did not address the issues
Qualified Foreign Pension Funds: Section 897(l)
Foreign Investment in Real Property Tax Act (FIRPTA): Background

- FIRPTA provides an important exception to the general rule that foreign investors are not subject to U.S. tax on capital gains

- FIRPTA generally treats gain recognized by a foreign person from the sale of a U.S. real property interest (USRPI), including shares of a U.S. real property holding corporation (USRPHC), as effectively connected income (ECI) subject to U.S. tax

- FIRPTA also imposes tax on certain distributions from a REIT that are attributable to the REIT’s sale of USRPIs (sometimes referred to as “897(h)(1) distributions”)

- There are various exceptions to the above rules:
  - “Domestically controlled REIT” exception
  - “Publicly traded” exception for shareholders that own 5% or less (10% or less in the case of a REIT)
  - Cleansing exception (not applicable to REITs)
FIRPTA and Qualified Foreign Pension Fund (QFPF) Exemption: Overview

- Section 897(l), enacted in 2015, provides an exemption from FIRPTA for QFPFs and any entity all the interests of which are owned by a QFPF
  - Technical corrections as part of TCJA clarified certain ambiguities in the original drafting
- Under Section 897(l), a QFPF’s gain on sale of shares of a USRPHC (including a foreign-controlled REIT) is completely exempt from U.S. tax under FIRPTA (and, therefore, generally exempt from U.S. tax)
  - Similarly, the exemption also applies to any distributions (including Section 897(h)(1) distributions) received by a QFPF from a REIT
- What’s a QFPF: Under the statute, a QFPF is any trust, corporation, or other organization or arrangement:
  - that is created or organized under the law of a country other than the United States,
  - is established to provide qualifying retirement or pension benefits,
  - in which no single participant/beneficiary has a >5% interest in its assets or income,
  - that is subject to certain government regulation and reporting requirements, and
  - that is subject to certain favorable tax treatment under the laws of the jurisdiction in which it is established
QFPFs: Guidance

- Proposed regulations under Section 897(l) published on June 6 2019; topics addressed include:
  - Qualified Controlled Entities (QCEs)
    - An entity wholly owned by *multiple* QFPFs (directly or indirectly through QCEs or partnerships) generally qualifies for the exemption as a QCE
      - But see anti-avoidance rule for entities that were not QFPFs or QCEs during a testing period of up to 10 years
  - Types of Plans
    - Multi-employer and government-sponsored plans can qualify as QFPFs, as can plans organized by trade unions, professional associations or similar groups
  - Limitations on Types of Benefits
    - Up to 15% non-pension/non-retirement benefits permitted, but only if all benefits “qualified” (e.g., death, disability, medical, unemployment)
  - Limitation on >5% Participants
    - Section 267 and Section 707 principles taken into account in determining whether any participant has a >5% interest
  - Information Reporting Requirement
    - Annual reporting of benefits to recipients generally required
    - Government-administered plans deemed-compliant
  - Required Local Law Tax Treatment
    - At least 85% of income exempt or contributions deductible, or other “substantially similar” regimes
    - Deemed satisfied if jurisdiction has no income tax
Disguised Sales:
Section 707
Section 707

- **Debt Financed Distributions**
  - The Section 707 disguised sale rules contain an exception for debt financed distributions; the exception may apply to money transferred to the contributing partner from proceeds of a recent partnership borrowing to the extent the distributed amount does not exceed the partner’s allocable share of that liability.
  - Temporary and proposed regulations published on October 5, 2016 treat all Section 752 liabilities as nonrecourse for purposes of the Section 707 disguised sale rules; thus, a partner’s allocable share of a Section 752 liability is the partner’s “% of partnership profits” as determined under tier 3 nonrecourse liability allocation rules of Section 752, subject to certain limitations.
  - Attempt to shut down leveraged partnership transactions using guarantees.
  - Proposed regulations published on June 19, 2018 (1) remove the 2016 temporary regulations issued under Section 707 and (2) reinstate the prior rules under former Treas. Reg. § 1.707-5(a)(2).
    - Taxpayers may rely on the 2018 proposed regulations.
    - Recourse liabilities may be allocated using the Section 752 recourse liability allocation rules; thus, certain guarantees may be used to avoid disguised sale treatment.
  - IRS continues to study the issue.
  - Final regulations on the priority guidance plan.
  - Timing?

- **Guidance on Section 707 disguised sales**, including disguised sales of partnership interests, on the priority guidance plan.
Partnership Liabilities: Section 752
Section 752

- Partnership recourse liabilities
  - Temporary and proposed regulations were published on October 5, 2016
  - Bottom dollar guarantees not effective to create economic risk of loss
  - The temporary regulations expire October 5, 2019
  - Section 7805(e) provides that a temporary regulation expires (sunsets) within three years of issuance, which is the date the regulation is filed for public inspection with the Federal Register
  - Final regulations on priority guidance plan
  - Timing?

- Section 752 related person rules
  - Proposed regulations were published on December 16, 2013
  - Modified the related person rules
  - Final regulations on priority guidance plan
  - Substance?
  - Timing?
Other Priority Guidance Plan Items
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- Final BBA regulations addressing (1) adjustments to bases and capital accounts and the tax and book basis of partnership property and (2) operation of certain international provisions in the context of the centralized partnership audit regime
  - Proposed regulations were published on February 2, 2018 and on November 30, 2017, respectively
- Final regulations under Section 469(h)(2) concerning limited partners and material participation
  - Proposed regulations were published on November 28, 2011
- Final regulations on the fractions rule under Section 514(c)(9)(E)
  - Proposed regulations were published on November 23, 2016
- Final regulations under Sections 704, 734, 743, and 755 arising from the American Jobs Creation Act of 2004 regarding the disallowance of certain partnership loss transfers and no reduction of basis in stock held by a partnership in a corporate partner
  - Proposed regulations were published on January 16, 2014
- Final regulations under Sections 761 and 1234 on the tax treatment of noncompensatory partnership options
  - Proposed regulations were published on February 5, 2013
Questions?