

ARTICLES

Using Tax Partnerships to Trigger Loss in the Commercial Real Estate Market

by Aaron P. Nocjar, Esq.*

INTRODUCTION

In today's floundering commercial real estate market, taxpayers are likely to find that assets that once had unrealized built-in gain now have unrealized built-in loss. Taxpayers are also likely to understand that recognizing built-in losses can lead to real fiscal savings. One way to recognize a built-in loss is to sell the relevant asset outright. However, taxpayers may not want to sell at such depressed prices or to lose complete control over an income-producing asset, particularly if they are optimistic about its future business prospects. In order to retain control and rights to future income with respect to such an asset while also recognizing its built-in loss, taxpayers can utilize a partnership structure.

This article describes this partnership structure, identifies the primary tax issues involved, and highlights some of the relevant pressure points.

INITIAL FACTS

Consider the following scenario.

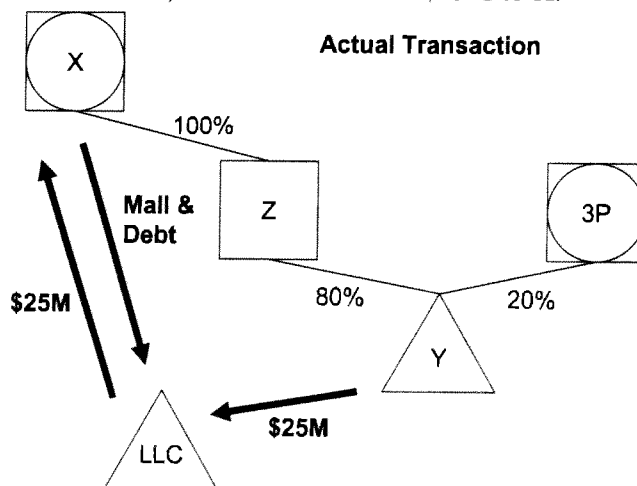
X, a commercial real estate developer classified as an S corporation for tax purposes, owns and operates, among other assets, a mall. To simplify, assume that the mall comprises a single asset (the "mall"). Several years ago, X had a built-in gain of \$100M in the

mall, due mainly to an increase in the fair market value of the mall since commencing operations. The mall was located in an area that saw tremendous residential growth over the past 20 years. Unfortunately, today, all of that appreciation (and residential growth) has disappeared, and the fair market value of the mall has dipped below X's adjusted tax basis by \$100M. The mall has served as security for \$50M of nonrecourse debt of X for the past 10 years. So, now, X holds the mall with an unrealized built-in loss of \$100M (i.e., a \$100M fair market value less \$200M of adjusted tax basis).

X continues to be under tremendous pressure to reduce expenses and raise capital to avoid defaulting on other development projects related to the mall. If X could recognize any portion of its \$100M unrealized built-in loss in the mall in 2010, X could really reduce this pressure.

Accordingly, X enters into the following transaction in 2010.

X and one of its indirectly affiliated partnership subsidiaries, Y, agree to form a limited liability company taxed as a partnership (the "LLC"). A wholly owned C corporation subsidiary of X ("Z") owns 80% of Y, and an unrelated third-party S corporation owns the remaining 20% of Y. X contributes the mall and the related nonrecourse debt to the LLC. Y contributes \$25M to the LLC. Immediately after these contributions, the LLC distributes \$25M to X.



What are the likely tax consequences?

GENERAL TAX RULES

Generally, pursuant to §721, a contribution of property by a partner to a partnership does not trigger the recognition of gain or loss for the partner, and, pursuant to §731, a distribution of cash not in excess of a partner's adjusted tax basis in its interest in the partnership does not trigger gain or loss recognition for the distributee partner. However, §707(a)(2)(B) can

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override this nonrecognition treatment in certain circumstances. Section 707(a)(2)(B) provides that if (i) there is a direct or indirect transfer of money or property by a partner to a partnership, (ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and (iii) the transfers, when viewed together, are properly characterized as a sale or exchange of property, then such transfers shall be treated either as a transaction between one who is not a partner and the partnership or as a transaction between two partners other than in their capacity as members of the partnership. In other words, if the conditions described in §707(a)(2)(B) exist, a tax-free contribution of property to, and a tax-free distribution of cash from, a partnership will be converted, in whole or in part, into a taxable sale of property to the partnership (i.e., a disguised sale).

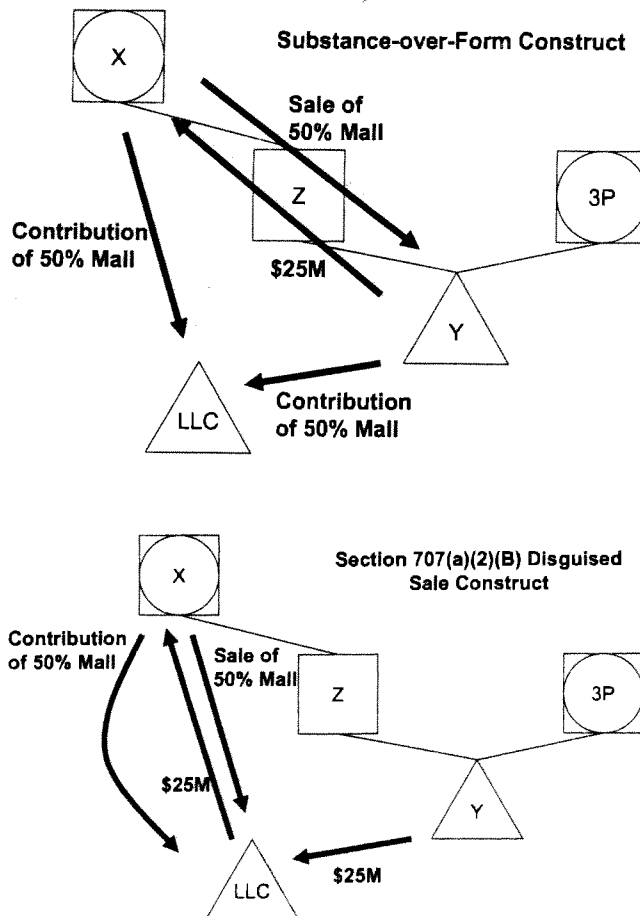
The usual goal in the disguised sale context is to avoid such treatment (and preserve nonrecognition treatment under §§721 and 731) while still pulling cash out of the partnership. This is typically done through the use of a leveraged partnership structure, guaranteed payments, preferred returns, reimbursements of preformation expenses, and guarantees of partnership debt by the contributing partner.¹ Of course, this usual exercise involves contributions of *appreciated* property (i.e., built-in gain property). These are not usual times.

In the built-in loss context, the object is to plan *into* a disguised sale. In other words, take the “disguised” out of the “disguised sale.” Under the §707(a)(2)(B) regulations, if the two transfers described in §707(a)(2)(B) occur within two years of each other, the transfers are presumed to be a disguised sale of property.² Further, if the transfers are simultaneous, the transfers are treated as a disguised sale if the second transfer would not have been made but for the making of the first transfer.³ Also, apart from §707(a)(2)(B), general federal tax principles can cause a purported tax-free contribution of property followed by a purported tax-free distribution of cash to be treated as a sale of such property if the substance of such transactions is that of a sale rather than a contribution of property in exchange for equity.⁴

Under either of these tests, the transaction entered into by X and the LLC should constitute, in part, a disguised sale of the mall and, in part, a tax-free contribution of the mall to the LLC in exchange for an

interest in the LLC. What is not clear is to whom X is treated as selling a portion of the mall.

Under substance-over-form principles, it seems that X should be treated as selling a portion of the mall to Y, followed by Y contributing such portion of the mall to the LLC in exchange for an interest in the LLC.⁵ Alternatively, under the §707(a)(2)(B) rules, X should be treated as selling a portion of the mall directly to the LLC. Because the funds used to make the \$25M distribution from the LLC to X originated with Y (as opposed to the funds originating from an LLC-level financing or other pre-existing liquid funds of the LLC), case law suggests that the disguised sale of a portion of the mall should be between X and Y (rather than between X and the LLC).⁶



Under either construct, X realizes \$50M of its unrealized built-in loss in the mall, and the remaining \$50M of the unrealized built-in loss rests both in X’s interest in the LLC and in the mall itself, now held by the LLC. Note, however, that, if the facts were different, X could have varying tax results depending on

¹ See Regs. §§1.707-4, -5(b).

² Regs. §1.707-3(c).

³ Regs. §1.707-3(b).

⁴ See, e.g., *Jacobson v. Comr.*, 96 T.C. 577 (1991), *aff’d per curiam*, 963 F.2d 218 (8th Cir. 1992); see also Regs. §§1.721-1(a), 1.731-1(c)(3).

⁵ See, e.g., *Jacobson v. Comr.*, 96 T.C. 577 (1991), *aff’d per curiam*, 963 F.2d 218 (8th Cir. 1992). *Cf.* Rev. Rul. 99-5, 1999-1 C.B. 434.

⁶ See *Jacobson v. Comr.*, 96 T.C. 577 (1991), *aff’d per curiam*, 963 F.2d 218 (8th Cir. 1992).

which construct applied. For example, if a portion of the \$25M cash distribution from the LLC was to reimburse X for pre-formation expenditures with respect to the mall, that portion would not be treated as part of a disguised sale in the §707(a)(2)(B) construct, but arguably could be treated as part of a disguised sale in the substance-over-form construct.⁷

If the transaction is treated as a disguised sale of a portion of the mall to Y, followed by contributions by X and Y of their respective interests in the mall to the LLC, then the following tax consequences should arise.

Because (i) X transferred property with a fair market value of \$100M, (ii) X received \$25M of cash, and (iii) X was relieved ultimately of 50% of the \$50M of debt (i.e., \$25M) at the end of the transaction due to the nonrecourse debt sharing rules under §752, X should be treated as selling an undivided 50% interest in the mall to Y.⁸ Thus, X's amount realized should be the \$25M of cash received plus the \$25M of debt relief.⁹ The adjusted tax basis of the undivided portion of the mall treated as sold to Y should be 50% of X's overall adjusted tax basis in the mall (i.e., 50% of \$200M = \$100M).¹⁰ Therefore, X should realize \$50M of loss (i.e., \$50M of amount realized – \$100M of basis).¹¹

X also should be treated as contributing the remaining 50% undivided interest in the mall to the LLC in exchange for an interest in the LLC in a tax-free contribution described in §721. So, X should be treated as contributing an undivided 50% portion of the mall with an adjusted tax basis of \$100M. Also, it appears that, due to the nonrecourse debt-sharing rules, the transfer by X of the remaining 50% interest in the debt to the LLC should not result in a net deemed distribution or contribution of cash.¹² This should result in X taking a \$100M adjusted tax basis in its interest in the LLC,¹³ so X should retain the remaining \$50M of unrealized built-in loss in its interest in the LLC (and the LLC should retain the same amount of unrealized built-in loss in the mall itself, but only for X's benefit).¹⁴

Alternatively, if the transaction is treated as a disguised sale of a portion of the mall to the LLC pursuant to §707(a)(2)(B), the following tax consequences should arise.

Because (i) X transferred property with a fair market value of \$100M, (ii) X received \$25M of cash, and (iii) X was relieved ultimately of 50% of the \$50M of debt (i.e., \$25M) at the end of the transaction due to the nonrecourse debt-sharing rules under §752, the portion of the mall that X should be treated as selling to the LLC should be an undivided 50% interest in the mall.¹⁵ X's amount realized should be the \$25M of cash received plus the \$25M of debt relief.¹⁶ The adjusted tax basis of the undivided portion of the mall treated as sold to the LLC should be 50% of X's overall adjusted tax basis in the mall (i.e., 50% of \$200M = \$100M).¹⁷ Thus, X should be treated as realizing \$50M of loss (i.e., \$50M of amount realized – \$100M of tax basis).¹⁸

Under the §707(a)(2)(B) regulations, the related nonrecourse debt is a "qualified liability."¹⁹ Usually, the transferring partner's deemed relief from the obligation to repay a qualified liability is disregarded in determining how much consideration the partner is treated as receiving in the disguised sale.²⁰ However, a qualified liability cannot be ignored for this purpose when other related transfers from the partnership to the partner constitute disguised sale consideration as well.²¹

In the relevant transaction, X receives \$25M of cash from the LLC, which is disguised sale consideration. So, the transfer of the qualified liability of \$50M cannot be simply ignored. Because X is effectively relieved of 50% of the \$50M debt under the nonrecourse debt-sharing rules (as modified by the disguised sale rules), X should include \$25M of that debt in its amount realized when determining the amount of gain or loss realized in the disguised sale.²² This increases from 25% to 50% the share of the mall treated as sold and thereby increases the amount of loss realized by X from \$25M to \$50M.

X also should be treated as contributing the remaining 50% undivided interest in the mall to the LLC in exchange for an interest in the LLC in a tax-free contribution described in §721. Thus, X should be treated as contributing a 50% undivided portion of the mall with an adjusted tax basis of \$100M. Also, it appears that, due to the nonrecourse debt-sharing rules, the transfer by X of the remaining 50% interest in the debt to the LLC should not result in a net deemed dis-

⁷ See Regs. §1.707-4(d).

⁸ $(25M + 25M) / \$100M = 50\%$.

⁹ §1001(b); Regs. §§1.1001-1(a), -2(a).

¹⁰ Cf. Regs. §1.1011-2(b).

¹¹ §1001(a).

¹² Regs. §§1.752-1(f), -3.

¹³ §§722, 752.

¹⁴ §§704(c)(1)(C), 723.

¹⁵ $(25M + 25M) / \$100M = 50\%$.

¹⁶ §1001(b); Regs. §§1.1001-1(a), -2(a).

¹⁷ Regs. §1.707-3(a)(2), (f) Ex. 1.

¹⁸ §1001(a).

¹⁹ Regs. §1.707-5(a)(6).

²⁰ Regs. §1.707-5(a)(5).

²¹ See *id.*

²² Regs. §1.707-5(a)(2), (5).

tribution or contribution of cash.²³ This should result in X taking a \$100M adjusted tax basis in its interest in the LLC.²⁴ So, X should retain the remaining \$50M of unrealized built-in loss in its interest in the LLC (and the LLC should retain the same amount of unrealized built-in loss in the mall itself, but only for X's benefit).²⁵

THE LOSS DISALLOWANCE PROVISIONS

Now, all that has been established is that X *realizes* \$50M of its unrealized built-in loss in the mall. As we all know, realization is only half the game. The Internal Revenue Code is littered with provisions that turn realized losses into disallowed (or unrecognized) losses. Two of those provisions are §§267 and 707(b).

Section 267, in relevant part, disallows losses arising from the sale or exchange of property, directly or indirectly, between certain specified persons. Section 267(b) contains a laundry list of those specified persons. One set of these specified persons seems relevant to this exercise. Section 267(b)(10) effectively provides that losses shall be disallowed that arise from a sale or exchange of property between a corporation and a partnership if the same persons own more than 50% in value of the stock of the corporation and more than 50% of the capital interest, or the profits interest, in the partnership. If §267 disallows a loss from the sale or exchange of property, any gain from the subsequent sale or other disposition of such property is reduced by such disallowed loss.²⁶ Constructive ownership rules also apply to widen the loss disallowance net.²⁷

Thus, under the substance-over-form construct, above, it seems that §267(b)(10) would disallow the \$50M loss realized. Under the constructive ownership rules of §267, the interests in Y owned by Z (i.e., 80% of such interests) are deemed to be owned by X, and then such interests deemed to be owned by X are further deemed to be owned by X's shareholders. So, the same persons (i.e., the shareholders of X) own more than 50% in value of the stock of the corporation (X) and more than 50% of the capital interest, or the profits interest, in the relevant partnership (Y). Therefore, §267 should disallow the entire \$50M of loss realized by X in the substance-over-form construct.

Note, however, that there is a line of authority that could be viewed as disallowing only 80% of such

loss. Regs. §1.267(b)-1(b), in relevant part, provides that a sale or exchange of property between a "person other than a partner" and a partnership shall be considered as occurring between the other person and the members of such partnership separately. Thus, if the other person and a member of a partnership fall within any of the categories of specified persons in §267(b), no loss shall be allowed to the other person "to the extent the related partner acquires an interest in any property sold to or exchanged with the partnership by such other person." A related example interprets the phrase "acquires an interest in any property" as including the situation where the partner simply acquires an indirect interest in property via its status as a partner in the partnership.²⁸

Thus, in the substance-over-form construct, X is the "person other than a partner," Y is the relevant partnership, and Z and the unrelated third party are the members of the relevant partnership. Because Z is wholly owned by X, X and Z fall into one of the categories of specified persons in §267(b).²⁹ However, the unrelated third party does not fall into any of those categories. So, Z constitutes the related partner, and Z's interest in the property sold to the relevant partnership (Y) is 80%. Therefore, one could take the view that, pursuant to Regs. §1.267(b)-1(b), X need only have 80% of its \$50M loss disallowed under §267.

The primary reason for this ambiguity is that the §267 regulations have not been updated for the enactment of §267(b)(10). If §267(b)(10) did not exist, there would be no other specified relationship in §267(b) that would capture the sale of the 50% interest in the mall between X and Y in the substance-over-form construct. In that case, Regs. §1.267(b)-1(b) would serve as the only loss disallowance rule in this context, which could lead to the conclusion that only 80% of the \$50M loss should be disallowed under §267. Unfortunately, §267(b)(10), in fact, exists.

One might take the view that Regs. §1.267(b)-1(b) can be read to have meaning in conjunction with §267(b)(10). For example, one might argue that (i) §267(b)(10) merely describes the factual circumstances in which the operative loss disallowance provision of §267(a) applies, (ii) §267(a) is somewhat unclear regarding *how much* of the relevant loss should be disallowed, and (iii) Regs. §1.267(b)-1(b) clears up that uncertainty. Unfortunately, §267(a) appears to be airtight in this respect — "no deduction shall be allowed in respect of *any* loss . . . between persons specified" in §267(b).

In the disguised sale construct, §267 may not appear to apply, because the sale transaction is treated as

²³ Regs. §§1.752-1(f), -3.

²⁴ §§722, 752.

²⁵ §§704(c)(1)(C), 723.

²⁶ §267(d).

²⁷ §267(c).

²⁸ Regs. §1.267(b)-1(b)(2) Ex. 2.

²⁹ See §267(b)(3).

occurring between a partner (X) and its partnership (the LLC). In fact, Regs. §1.267(b)-1(b)(1) states: “Since §267 does not include members of a partnership and the partnership as related persons, transactions between partners and partnerships do not come within the scope of §267.” However, upon further analysis, the plain language of §267(b)(10), coupled with the constructive ownership rules, again work to disallow the \$50M loss realized, as the same persons (X shareholders) own (directly, or indirectly by attribution) more than 50% in value of the stock of the corporation (X) and more than 50% of the capital interest, or the profits interest, in the relevant partnership (the LLC).

Just in case one did not think that complete loss disallowance under §267 was enough, the Internal Revenue Code supplies yet another relevant loss disallowance provision — §707(b).

Section 707(b), in relevant part, disallows losses arising from the sale or exchange of property (other than an interest in a partnership), directly or indirectly, between a partnership and a person owning, directly or indirectly, more than 50% of the capital interest, or the profits interest, in such partnership. Similar to §267, if §707(b) disallows a loss from the sale or exchange of property, any gain from the subsequent sale or exchange of such property is reduced by such disallowed loss. Except for an exception irrelevant to this exercise, the constructive ownership rules of §267 are imported into §707(b).³⁰

Applying §707(b) to the sale of the undivided 50% interest in the mall in both the substance-over-form construct (sale to Y) and the disguised sale construct (sale to the LLC), §707(b) should disallow the entire \$50M realized loss. In the substance-over-form construct, the parties that comprise the relevant “person-partnership relationship” are X and Y, respectively, via the constructive ownership rules. In the disguised sale construct, the parties that comprise the relevant “person-partnership relationship” are X and the LLC, respectively. Unlike in the §267 analysis, there appears to be no room to argue that only 80% of the \$50M loss should be disallowed in the substance-over-form construct. Section 707(b) does not have rules analogous to Regs. §1.267(b)-1(b).

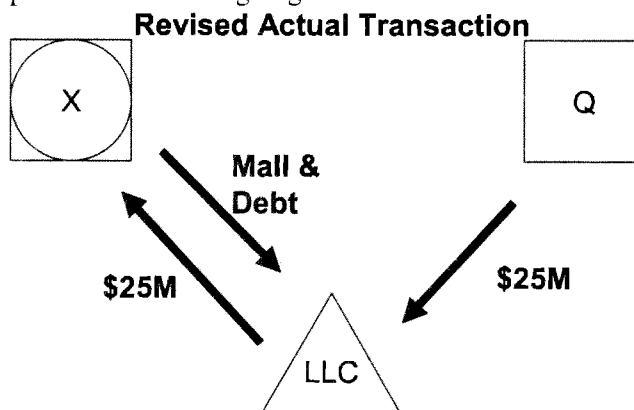
REVISED FACTS

As a result of §§267 and 707(b), this transactional structure does not seem to get X where it wants to go. How can X modify the structure to convert some of that \$50M loss realized into loss recognized? Put another way, how can X avoid the loss disallowance provisions of §§267 and 707(b)?

³⁰ §707(b)(3).

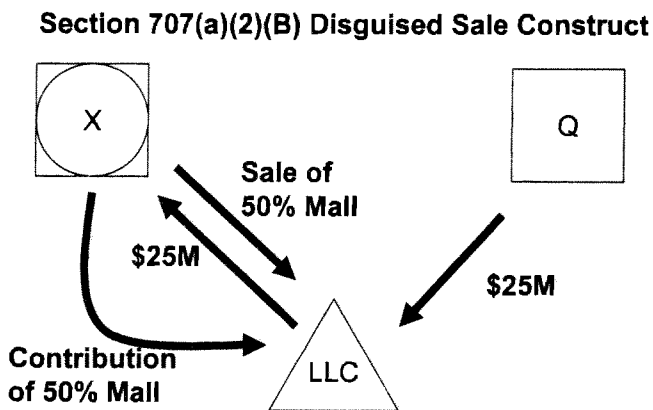
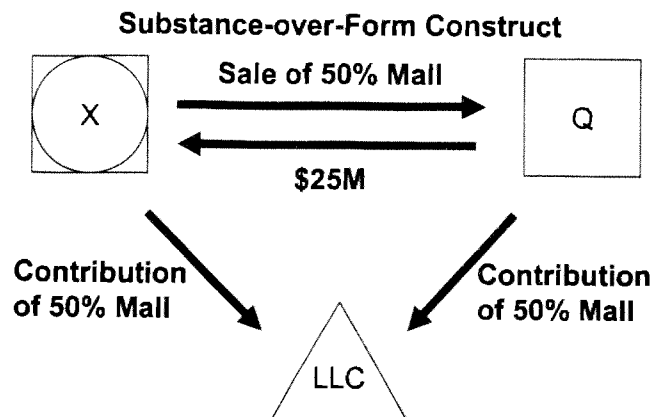
Both provisions apply a “more than 50%” relatedness threshold. Both provisions also apply this relatedness threshold to a partner’s “capital interest” or “profits interest.” In other words, the potential relatedness exists if the “more than 50%” threshold is satisfied with respect to a capital interest or a profits interest. It is not necessary to satisfy both. So, the object in recognizing built-in loss in these situations is to keep the relatedness at 50% or below with respect to a partner’s “capital interest” and “profits interest.”

Assume the factual scenario involving X described above and modify it as follows. Instead of X’s corporate and partnership subsidiaries engaging in the transaction with X, X attracts an unrelated C corporation investor to participate in the transaction — Q. As in the originally described transaction, X contributes the mall and the related nonrecourse debt to the LLC, and Q contributes \$25M to the LLC. Immediately after these contributions, the LLC distributes \$25M to X. Both X and Q have 50% interests in the capital and profits of the LLC going forward.



Have the likely tax consequences changed from the original scenario?

Like the original scenario, X should be treated as selling 50% and contributing 50% of the mall. Like the original scenario, the sale of 50% of the mall could be treated as occurring between X and Q pursuant to substance-over-form principles, or between X and the LLC pursuant to the §707(a)(2)(B) disguised sale of property rules. Like the original scenario, regardless of the direction of the sale, X should realize \$50M of its unrealized built-in loss in the mall, and the remaining \$50M of unrealized built-in loss should rest both in X’s interest in the LLC and in the mall itself, now held by the LLC.



In the original scenario, the \$50M realized loss was not recognized due to the fact that the relationships between X and its affiliate or between X and the LLC caused §§267 and 707(b) to apply. In the current scenario, neither §267 nor §707(b) should apply.

The key is that X does not have a greater than 50% capital interest or profits interest in the LLC. Congress expressly used the language “more than 50%” in §§267 and 707(b) — not “50% or greater.” Also, there appears to be no principled reason to use “50%” rather than “80%,” “40%,” or some other level. The 50% level seems to stand as a generic line drawn in the sand. Therefore, an argument that relationship levels drawn up right at the 50% line also should be subject to limitation (or special scrutiny) under §§267 and 707(b) should have no traction. Nonetheless, due to the difficulties in measuring a partner’s interest in capital and profits for this purpose (further discussed below), one should exercise a healthy amount of caution when determining how close one wants to get to the 50% line.

Now, X likely will not want to give up control over the management and operations of the mall in such a transaction. X likely will want to ensure that the management and operation of the mall remain unchanged. Would X having a 100% voting and management interest in the LLC cause §267 or §707(b) to disallow

X’s \$50M realized loss? No. Both loss provisions focus solely on financial relationships. Unlike other Code provisions that use relatedness keys (such as §482),³¹ the fact that X continues to control completely the management and operations of the LLC should not be treated as pushing X’s level of relatedness over 50%.³²

In addition to not giving up management and operational control, X also may not want to give up 50% of all potential upside in the mall. X may want to retain the right to share in, for example, 80% of the profits of the LLC if and to the extent the management and operation of the mall generates LLC revenues in excess of some fixed threshold. For example, the fixed threshold could be \$30M of annual gross rental revenue, where the current level of annual gross rental revenue is \$20M.

Does this additional contingent interest in the profits of the LLC cause X to be treated immediately as having a more than 50% profits interest in the LLC, which could cause the disallowance of X’s \$50M realized loss? Should X simply measure its profits interest in the LLC as it exists at the time of the sale/contribution of the mall so that the potential 80% profits interest is ignored? Alternatively, must X apply present value concepts so that some portion of the potential 80% profits interest is added to the current 50% profits interest?

There are no clear answers to these questions in the §267 or §707(b) context. However, another provision applicable to partnerships could shed some light. Section 706(b) controls the taxable year of a partnership. Generally, a partnership must use the “majority interest taxable year” as its taxable year.³³ Such year means the taxable year that constituted the taxable year of one or more partners having an aggregate interest in partnership profits and capital of “more than 50%.”³⁴ The determination of each partner’s interest in partnership profits and capital is to be made at the *start* of the partnership’s taxable year.³⁵ The relevant Treasury regulations provide generally that, if a partner’s share of partnership profits for the year depends on the amount or nature of partnership income for such year, then the partnership must make a “reasonable estimate” of the amount and nature of its income for such year.³⁶ Such estimate must be based on all

³¹ See Regs. §1.482-1(i).

³² However, such exclusive control over the LLC should be considered (along with all other facts and circumstances) in determining whether the LLC is a partnership for federal tax purposes.

³³ See §706(b)(1)(B).

³⁴ §706(b)(4).

³⁵ *Id.*

³⁶ Regs. §1.706-1(b)(4)(ii).

facts and circumstances known to the partnership as of the first day of such year.³⁷

There is no indication that such rules are to be applied beyond §706. However, they stand as an example of one approach that the Treasury Department and the Internal Revenue Service are comfortable using to determine partners' interests in capital and profits when such interests are contingent on future variables. The use of such a "reasonable estimate" approach would not seem to constrain significantly how one arrives at a partner's interest in capital or profits. Such an approach would seem to permit a fairly wide band of acceptable calculations.

It seems that, in the context of §§267 and 707(b), the more appropriate answer is that the potential 80% profits interest should be ignored. First, the structure of §§267 and 707(b) strongly suggests that the time that relatedness must be determined is at the time of the relevant sale or exchange — not at the end of the taxable year that includes the sale or exchange nor on an annual basis thereafter. Courts have concluded similarly.³⁸ Second, this type of future adjustment to X's profits interest is contingent as to its occurrence rather than only as to its amount. At the time of the sale/contribution of the mall to the LLC, the prospect of annual gross revenues increasing from \$20M to \$30M is only an aspirational business goal — an incentive to current management of X. Third, if such contingencies had to be taken into account, most similar transactions would fall prey to §§267 and 707(b) even without any express contingent increases in a partner's profits interest. For example, an allocation of income under a "qualified income offset" provision can constitute an allocation of 100% of a certain slice of profits from a partnership if, in fact, conditions that trigger such a provision materialize.³⁹ This is a provision that exists in most partnership agreements so as to increase the likelihood that a partnership's allocations of profits and losses will be respected for federal income tax purposes.⁴⁰ Other commonly used special allocation provisions also raise this issue, such as "partnership minimum gain" provisions and "partner minimum gain" provisions.⁴¹ For these three reasons, it seems that the more appropriate approach with respect to the contingent profits interest described above

is to ignore it in determining a partner's level of relatedness under §§267 and 707(b).

If, rather than a contingent profits interest, X were guaranteed an increasing share of LLC profits, could that cause X's profits interest to be treated as more than 50% for purposes of §§267 and 707(b)? For example, assume that, in five years, X's profits interest in the LLC should increase by 5 percentage points over its original 50% profits interest. Unlike the contingent profits interest described above, this future increase in X's profits interest in the LLC is not contingent as to occurrence. For this reason, one could conclude that it seems more appropriate in this situation to require X to include currently some portion (based on present value concepts) of this future increase in its profits interest in the LLC for §§267 and 707(b) purposes. However, one also could conclude that it still is more appropriate to disregard such delayed increase in X's profits interest, because (i) relatedness should be determined based on all the facts and circumstances that exist on the date of the sale/contribution of the mall and (ii) there are innumerable circumstances that could materialize in five years that could defeat the intended increase in X's profits interest, such as the LLC liquidating or X closing out its interest in the LLC in the interim. Five years is a long time in the transactional tax world.

If X were, in fact, viewed as having a more-than-50% profits interest or capital interest in the LLC so that the prohibited relationship existed as between X and the LLC, would §§267 and 707(b) disallow X's \$50M realized loss? If the relevant sale transaction were treated as occurring between X and the LLC under the §707(a)(2)(B) disguised sale rules, the answer is clearly "yes." However, recall that the relevant sale could be viewed as occurring between X and Q (rather than the LLC) under substance-over-form principles. In that case, §707(b) apparently would not apply because the relevant sale would not be treated as involving the LLC — there would be no sale between a partner (or person related to a partner) and the partnership. Rather, the relevant sale would be treated as occurring between two partners. Further, §267 apparently would not apply because the two partners — X and Q — would not fall into any of the prohibited relationships described in §267(b).

However, both §267 and §707(b) also disallow losses realized in sales "indirectly" between related parties. Under the substance-over-form construct, could the transaction be viewed as an "indirect sale" of 50% of the mall from X to the LLC (parties that are assumed, in this additional hypothetical, to be related for §§267 and 707(b) purposes)?

The inclusion of "indirect" in these provisions seems to have been meant to prevent related parties from avoiding loss disallowance through the use of a

³⁷ *Id.*

³⁸ See, e.g., *Dyess v. Comr.*, 65 T.C.M. 2717 (1993), *aff'd per curiam*, 26 F.3d 1119 (5th Cir. 1994) (ruling that §707(b) "requires that a partner's percentage ownership of the capital interest or the profits interest be determined on a particular date, at the time the property is sold or exchanged, to establish the presence or absence of" the controlled relationships described in §707(b)).

³⁹ See Regs. §1.704-1(b)(2)(ii)(d).

⁴⁰ See *id.*

⁴¹ See Regs. §1.704-2.

multi-step transaction involving a third party where there is no “economically genuine realization [. . .] of loss.”⁴² For example, instead of X selling 50% of the mall directly to the LLC, X engages the services of an unrelated party to “buy” such portion of the mall from X and then “sell” it to the LLC shortly thereafter. It seems clear that the “indirect” language in §§267 and 707(b) would capture that technique.⁴³

Q, however, is no “straw man.” X does not control Q. Q holds an interest in the LLC for its own economic benefit.

Nonetheless, the relevant case law suggests that one could conclude that the substance-over-form construct should be captured in this context by the “indirect sale” language of §§267 and 707(b).⁴⁴ At the start of the transaction, X owns the mall in whole. At the end of the transaction, the LLC owns the mall in whole. The substance-over-form construct, similar to the construct adopted in Rev. Rul. 99-5,⁴⁵ simply routes a portion of the mall through the hands of Q on its way to the LLC for tax purposes. Q never actually takes possession of such portion of the mall. There is no moment in time where Q could halt the progress of such portion of the mall from X to its ultimate owner, the LLC. Case law addressing “indirect sales” in the §267 context indicates that “indirect sales” are not to be confined only to circumstances involving mere conduits, binding commitments to retransfer, or voluntary transfers.⁴⁶ Accordingly, a position, with respect to the substance-over-form construct, that X and the LLC entered into an “indirect sale” of 50% of the mall under §§267 and 707(b) appears reasonable.

OTHER TAX ISSUES

There are several other tax issues that arise in these types of transactions as well.

Often, Q will want to be guaranteed some level of return for its \$25M investment in the LLC. Preferred returns can be used to satisfy Q’s desires. However, care must be taken to prevent Q’s overall investment in the LLC from being recast as a creditor’s interest. If that occurred, the LLC would not be treated as a tax partnership but, rather, would be treated as a disre-

garded entity of X. Such disregarded treatment of the LLC would nullify the existence of the sale/contribution of the mall to the LLC, which would not only disallow the recognition of the \$50M loss but also nullify the initial realization of the \$50M loss.

If only the preferred-return portion of Q’s interest in the LLC were recast as debt, the existence of the LLC as a partnership would be preserved. However, the reduction of Q’s capital and/or profits interest due to the recast would correspondingly increase X’s capital and/or profits interest over the 50% relatedness thresholds. While the \$50M loss from the sale of the mall to the LLC would still be realized, it may no longer be recognized due to §§267 and 707(b).

Another tax issue arising in these types of transactions stems from the parties’ use of options with respect to economic upside or downside in the deal. X might want an option to reacquire the mall from the LLC or an option to purchase Q’s interest in the LLC. X might want such features to capture all (rather than just 50%) of the future upside in the mall after a certain “standstill” period in the LLC. X might also want this to prevent Q’s interest in the LLC from ending up in another, unwanted party’s hands. Q might want an option to force the sale of its interest in the LLC to X to protect against unexpected future downside attributable to the operation of the mall by the LLC. If the terms of these options are too aggressive so that it is substantially certain that such options will be exercised (or that there is only a remote possibility that such options will not be exercised), the mere issuance of the options could be treated effectively as the immediate exercise of such options.⁴⁷ Such treatment could cause the LLC to be treated as a disregarded entity of X from the outset, which would nullify the initial sale/contribution of the mall that caused the realization of the \$50M loss for X.

Yet another tax issue centers on the character of the resulting \$50M loss for X. X is not out of woods after it overcomes the loss disallowance provisions of §§267 and 707(b). If the character of the \$50M loss is long-term capital and X is classified as a C corporation, X may not be able to take it into account currently. X would need to determine whether it could absorb such a loss with long-term capital gain currently or in prior or subsequent years under the carry-back and carryover provisions in §1212. Further, X would need to determine whether the mall was §1231 property. If it did, the \$50M loss may be converted into an ordinary loss if X’s total 2010 losses from §1231 property equaled or exceeded X’s 2010 total

⁴² *McWilliams v. Comr.*, 331 U.S. 694 (1947).

⁴³ See, e.g., *Davis v. Comr.*, 88 T.C. 122 (1987), *aff’d*, 866 F.2d 852 (6th Cir. 1989); *Hassen v. Comr.*, 63 T.C. 175 (1974), *aff’d*, 599 F.2d 305 (9th Cir. 1979).

⁴⁴ See *Hassen v. Comr.*, 63 T.C. 175 (1974), *aff’d*, 599 F.2d 305 (9th Cir. 1979).

⁴⁵ 1999-1 C.B. 434.

⁴⁶ See *McWilliams v. Comr.*, 331 U.S. 694 (1947); *Davis v. Comr.*, 88 T.C. 122 (1987), *aff’d*, 866 F.2d 852 (6th Cir. 1989); *Hassen v. Comr.*, 63 T.C. 175 (1974), *aff’d*, 599 F.2d 305 (9th Cir. 1979).

⁴⁷ See, e.g., *Penn-Dixie Steel Corp. v. Comr.*, 69 T.C. 837 (1978); *Griffin Paper Corp. v. Comr.*, 74 T.C.M. 559 (1997); *Kwiat v. Comr.*, 64 T.C.M. 327 (1992); Rev. Rul. 72-543, 1972-2 C.B. 87; FSA 1998 WL 1984538 (9/1/98).

gains from §1231 property.⁴⁸ If that were the case, X then would need to determine whether it could absorb such loss with ordinary income currently or in prior or subsequent years under the carryback and carry-over provisions in §172. Further, such §1231 ordinary loss would be subject to recapture if and to the extent, in any year within 5 years after the sale of the mall to the LLC, X's total gains from §1231 property exceeded X's total losses from §1231 property.⁴⁹ If, instead, X were classified as a tax partnership or an S corporation, each partner/shareholder, first, would need to determine whether it had sufficient basis in its interest in X (or in any debt from X in the S corporation context) to take into account its allocable share of X's loss and, second, would need to make all of the §§1212 and 1231 determinations described above at the investor level (rather than at the corporate level).⁵⁰ Also note that these character issues can get much more complicated when one lets reality seep into the factual picture, thereby removing the assumption that the mall comprises a single, collective asset.

No discussion of potential tax issues in a partnership deal would be complete without a mention of the "soft doctrines." One must consider whether the terms of the deal could trigger the application of any of the following doctrines:

- the court-made economic substance doctrine,
- the §7701(o) economic substance doctrine,
- the partnership anti-abuse rule of Regs. §1.701-2,
- the general substance-over-form principles, and
- the rules under §165 regarding the determination of whether a recognized loss may be deducted.⁵¹

All of these doctrines should be considered as potentially applicable to X's transaction. If any of these doctrines were to apply, they could result in the disregard of the existence of the LLC, the existence of Q as a member of the LLC, or the sale of the mall by X.

It seems that, among all the relevant factors to address in analyzing whether these "soft doctrines" ap-

ply, the factor that deserves the most attention in this context is business purpose. Does X's sale of 50% of the mall, directly or indirectly, to the LLC serve a legitimate business purpose?

While X's transaction certainly could serve other legitimate business purposes, one might also take the position that X's transaction serves a legitimate business purpose of keeping the mall's doors open. The money generated from the recognition of X's built-in loss in the mall would be used to avoid job loss with respect to the mall and to continue expansion projects involving the mall. Such a position has not always fared well in the eyes of the IRS and the courts.⁵² However, conditions in the commercial real estate market today are not typical business conditions. Recall that, as a result of failing business conditions in the real estate market in the 1970s due to, among other factors, skyrocketing interest rates, mortgage lenders were swapping interests in economically identical mortgages for the sole purpose of generating tax refunds from the recognition of built-in loss to shore up their financial positions. The U.S. Supreme Court held that such exchanges generated realized and recognized loss, despite the lack of any *non-tax* business purpose for such exchanges.⁵³ Consequently, taking such a position on business purpose in the context of X's transaction might not be as repugnant to the IRS or the courts today in light of the current condition of the commercial real estate market.

CONCLUSION

Taxpayers in the commercial real estate business today should be able (and likely need) to unlock the tax benefits associated with the economic depreciation of their assets. One way to access those tax benefits is through the use of a tax partnership with an unrelated third party. There are several tax issues to consider, but none should stand as an insurmountable obstacle as long as the taxpayer structures the deal appropriately.

⁴⁸ §1231(a)(2).

⁴⁹ See §1231(c).

⁵⁰ See §§702(a)(1)-(3), 703(a)(2), 1366(a)(1)(A), 1366(d); Regs. §§1.702-1(a)(1)-(3), 1.702-2, 1.1366-1(a)(2)(i) and (ii), 1.1366-1(e).

⁵¹ See Regs. §1.165-1(b).

⁵² See, e.g., *American Electric Power Co., Inc. v. U.S.*, 326 F.3d 737 (6th Cir. 2003).

⁵³ See *Cottage Savings Association v. Comr.*, 499 U.S. 554 (1991).