



ABA Section of Taxation Letter to Senate Finance Committee, House Ways and Means Committee on Tax Reform in Real Estate, Daily Tax Report (BNA)

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Daily Tax Report®

March 12, 2013

ABA Section of Taxation Letter to Senate Finance Committee, House Ways and Means Committee on Tax Reform in Real Estate

March 11, 2013

The Honorable Max S. Baucus Chairman Senate Committee on Finance 219 Dirksen Senate Office Building Washington, DC 20510-6200	The Honorable Dave Camp Chairman House Committee on Ways & Means 1102 Longworth House Office Building Washington, DC 20515
The Honorable Orrin G. Hatch Ranking Member Senate Committee on Finance 219 Dirksen Senate Office Building Washington, DC 20510-6200	The Honorable Sander Levin Ranking Member House Committee on Ways & Means 1102 Longworth House Office Building Washington, DC 20515

Re: Options for Tax Reform in Real Estate

Dear Chairmen and Ranking Members:

Enclosed please find a description of options for tax reform in real estate. These options for tax reform are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

These options are submitted as part of a series of tax reform options prepared by the American Bar Association Section of Taxation, the objectives of which are to improve the tax laws and to make them simpler to understand and administer.

The Section would be pleased to discuss the options with you or your staffs if that would be helpful.

Sincerely yours,

Chair, Section of Taxation

Former Chair, Section of Taxation

Enclosure

cc: Mr. Russell Sullivan, Majority Staff Director, Senate Finance Committee

Mr. Christopher Campbell, Minority Staff Director, Senate Finance Committee

Ms. Jennifer Safavian, Majority Staff Director, House Ways and Means Committee

Ms. Janice A. Mays, Minority Chief Counsel, House Ways and Means Committee

Mr. Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation

Honorable Mark J. Mazur, Assistant Secretary (Tax Policy), Department of the Treasury

Honorable William J. Wilkins, Chief Counsel, Internal Revenue Service

Honorable Steven T. Miller, Acting Commissioner, Internal Revenue Service

AMERICAN BAR ASSOCIATION SECTION OF TAXATION

OPTIONS FOR TAX REFORM IN REAL ESTATE

These options for tax reform ("Options") are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

These Options are submitted as part of a series of tax reform options by the Section of Taxation of the American Bar Association, the objectives of which are to improve the tax laws and to make them simple to understand and to administer. Principal responsibility for preparing these Options was exercised by Andrea M. Whiteway of the Real Estate Committee. Substantive contributions were made by Steven P. Berman, Jill E. Darrow, Bill Elliott, Jon Finkelstein, Jerome Garciano, Peter Genz, Michael Hirschfeld, Robert Honigman, Eliot Kaplan, Todd Keator, Michael Luttig, David A. Miller, Joshua Milgrim, Julie Sassenrath, Robert Schachat, James Sowell, Darryl Steinhouse, Christopher Whitcomb and Fred Witt. The Options were further reviewed by Michael Cook of the Section's Committee on Government Submissions and by Eric Sloan, Council Director of the Real Estate Committee.

Although the members of the Section of Taxation who participated in preparing these Options have clients who would be affected by the federal tax principles addressed by these Options or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Options.

Contact Persons:

Andrea M. Whiteway

Phone: (202) 756-8425

Email: awhiteway@mwe.com

Eliot Kaplan

Phone: (602) 528-4036

Email: eliot.kaplan@ssd.com

Date: March 11, 2013

Executive Summary

1. **Section 42(b)(2): Low-Income Housing Tax Credit.** The low-income housing tax credit ("LIHTC") may be claimed annually over a ten-year period ("Credit Period") after each low-income building is placed-in-service. The amount of the credit for any taxable year in the Credit Period is the applicable percentage of the qualified basis of each qualified low-income building. The applicable percentage for a low-income building is determined by a complicated methodology. Our proposed option would simplify the determination of the applicable percentage by fixing the percentages at nine percent and four percent.

2. **Section 42(i): Low-Income Housing Tax Credit.** The LIHTC is claimed annually over the Credit Period that begins when a low-income building is placed in service or, at the irrevocable election of the taxpayer, in the succeeding taxable year. The low-income portion of a project must be maintained as such for 15 years, beginning with the commencement of the Credit Period (the "Compliance Period"), or credits will be subject to recapture. Our proposed option would change these provisions to simplify the interaction between the Credit Period provisions and the Compliance Period provisions by providing a ten-year period for both. The proposed option would provide a Compliance Period of ten taxable years beginning with the first taxable year of the Credit Period and extend the extended use period to 20 years after the close of the Compliance Period.

3. Section 42(g)(3): Low-Income Housing Tax Credit. A “qualified low-income housing project” is a project for “residential rental property” that satisfies both a tenant-income requirement and a rent-restriction requirement. If a building is part of a project consisting of multiple buildings, other buildings placed in service by the end of the first year of the first building's Credit Period and designated by the taxpayer may be taken into account for purposes of determining whether the 20-50 test or 40-60 test has been satisfied with respect to both the first building and the other buildings, provided that, in the aggregate, the other buildings and the first building satisfy those tests by the end of the first year of the first building's Credit Period. Our proposed option would simplify the multiple building set-aside test by providing that minimum set aside for the entire project must be met no later than the close of the second year of the Credit Period.

4. Section 42(g)(7): Low-Income Housing Tax Credit. Pursuant to Regulation section 1.103-8(b), multiple buildings may be treated as part of a single project if they contain similarly constructed units and are owned by the same person, located on the same or contiguous parcels of real estate and financed pursuant to a common plan. However, buildings that could not be treated as a single project because of their lack of proximity may be so treated if all of the units in each building are rent restricted. Our proposed option would amend section 42(g)(7) to provide that buildings which would (but for their lack of proximity) be treated as a single project for purposes of this section shall be so treated if all the buildings are owned by the same person and financed pursuant to a common plan and, to simplify the development of mixed-income, scattered-site LIHTC projects, would also remove the requirement that all of the units in each building be rent restricted.

5. Section 42(j)(4)(E): Low-Income Housing Tax Credit. Under current law, if as of the close of any taxable year in the Compliance Period, the amount of the qualified basis of any building with respect to the taxpayer is less than the amount of such basis as of the close of the preceding taxable year, then the taxpayer's tax for the taxable year shall be increased by the credit recapture amount. Recapture does not apply to a reduction in qualified basis by reason of a casualty loss to the extent such loss is restored by reconstruction or replacement within a reasonable period established by the Secretary. If the loss is not restored prior to the year-end in which the loss occurs, the tax credits for the units out of service will be lost during the restoration of the property. Under our proposed option, recapture will not apply to a reduction in qualified basis by reason of a casualty loss to the extent such loss is restored by reconstruction or replacement within six months regardless of which tax year the loss is restored.

6. Section 47: Historic Tax Credit. There is considerable uncertainty as to whether an investor that is admitted to a partnership either owning an historic project eligible for historic tax credits or leasing such project from the owner in the case of a project utilizing a lease pass-through election must earn a “market” rate of return with respect to its investment without taking into account the historic tax credits that will be allocated to the investor. Our proposed option would codify the position of the Ninth Circuit in *Sacks v. Commissioner* to allow the developers of the historic tax credit projects and the tax credit investors to more efficiently utilize the tax credit subsidy by permitting them to structure the investment of the tax credit investor in a way that is more naturally based upon their business arrangement.

7. Section 47: Historic Tax Credit. The rules under section 47 generally require that certain minimum rehabilitation expenditures for certified historic structures be incurred during a 24-month measuring period. These rules do not adequately address the common fact patterns in which a large certified historic structure will be divided into separate condominium units under local real estate law, with different taxpayers owning the different units, and with only loose coordination among the owners as to the timing of the rehabilitation of the separate condominium units or where the rehabilitation is of certain large certified historic structures that must be developed in multiple phases. Under our proposed option, section 47 would be amended to treat different condominium units within an overall structure as separate buildings for purposes of the historic tax credit, provided that the condominium documents include mutual covenants among the condominium owners that all rehabilitation work will be performed in accordance with the standards of the National Park Service.

8. Section 50(d): Historic Tax Credit. Historic tax credits are “syndicated” by admitting into the lessee entity a tax credit investor that makes a significant capital contribution to that entity based entirely upon a reference in section 50(d)(5)(v). As a result, the basis for the current tax credit syndication market is a provision no longer included in the Code but preserved as it existed more than 20 years ago, at a time when the provision had much more limited application and had received far less use and scrutiny. Our proposed options include the following: (1) incorporating directly into section 47 the operative provisions pertaining to the master lease or lease pass-through election that could be made by a lessor to a lessee with respect to an historic tax credit project, and (2) clarifying the authority for utilizing the lease pass-through election and detailing the specific conditions that are imposed in connection with the election to significantly reduce the uncertainty and resulting transaction costs.

9. Section 108: Income from Discharge of Indebtedness. Recognizing that most discharges occur when debtors are

facing financial difficulties and are least able to pay tax, Congress enacted section 108. The repeal of the qualified business indebtedness exception, the repeal of the equity for debt exception, the narrowing of the definition of the insolvency exception and the repeal of the deduction for personal interest have created a “perfect storm” of problems and obstacles for debtors and creditors seeking to “work out” troubled debt and have created needless obstacles, complexity and impediments to the ability of debtors and creditors to “work out” troubled debt in an economic manner without the imposition of an immediate tax liability. Under our proposed option, all of the provisions of section 108 as originally enacted would be reinstated because the original version of section 108 was an optimal statutory regime that provided for an appropriate balance between the needs of the debtor and the government.

10. Section 110: Qualified Lease Construction Allowances. Section 110 was enacted to provide lessees of real property a safe harbor for “qualified lessee construction allowances” for short-term leases. Regulation section 1.110-1(b)(3) adds a “purpose requirement” for the safe harbor that requires language be included in the lease that is quite specific and, for lessees unfamiliar with the regulations under section 110, may well not be included in a lease. This issue is already addressed by the requirement under Regulation section 1.110-1(b)(5) that the lessor claim depreciation deductions for the cost of the leasehold improvements which is intended to avoid the lessor and lessee reporting inconsistently. Under our proposed option, section 110 would be amended to expressly provide that, for purposes of “qualified lessee construction allowances,” the lease agreement for the retail space does not require the express statement mandated by Regulation section 1.110-1(b)(3).

11. Section 167: Depreciation and Section 168: Accelerated Cost Recovery System. Section 167 provides as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property used in a trade or business or property held for production of income. The depreciable life of property varies by the type of property. We believe that the applicable recovery period of tangible property should reflect the economic useful life of such property. We recommend that a comprehensive study of the recovery periods of depreciable real estate be undertaken to determine and ensure that the applicable recovery periods are reflective of the economic useful lives of such assets. Under our proposed option, Congress would enact statutory depreciation periods for real estate that are consistent with the study.

12. Section 179D(d)(4): Energy Efficient Commercial Property Deduction. Section 179D provides a deduction for part or all of the cost of energy efficient commercial building property. Many of the designers that receive allocations of the section 179D deduction under section 179D(d)(4) are organized as partnerships or S corporations for federal tax purposes. A partner in a partnership or a shareholder in an S corporation who is entitled to a deduction under section 179D will be required to reduce his adjusted tax basis in his partnership interest or S corporation stock to reflect the impact of the deduction. As a result, a partner or shareholder in such a partnership or S corporation ultimately will not obtain the full benefit Congress intended when it enacted section 179D. In order to avoid this unintended consequence, our proposed option would amend section 179D(d)(4) to treat the partnership or S corporation as receiving income exempt from tax in an amount equal to the deduction allocated to it under section 179D(d)(4) so that the partners or shareholders will receive a basis increase under section 705 (in the case of a partnership) or section 1367(a)(1)(A) (in the case of an S corporation) equal to their allocable shares of the section 179D deduction.

13. Section 267: Sales Between Partnerships and a Related Nonpartner or Between Two Partnerships. In the 1986 amendment to section 707(b), the Senate Report indicated that section 707(b) was to exclusively govern sales between partnerships. The Service, however, takes the position that Regulation section 1.267(b)-1(b)(1) survives and its application causes some odd results. Under our proposed option, Congress would enact legislation that states that section 707(b) overrides Regulation section 1.267(b)-1(b)(1).

14. Section 291(a)(1): Special Rules Relating to Corporate Preference Items. Section 291(a)(1) recharacterizes a corporation's capital gain on the disposition of section 1250 property as ordinary income to the extent of 20% of the difference between: (i) the amount that would have been subject to recapture if the property had been subject to section 1245 and not section 1250, and (ii) the amount recaptured under section 1250. Under current law, a corporation does not have separate rate schedules for capital gain and ordinary income and thus such recharacterization does not result in an increased tax burden. Nevertheless, the recharacterization of capital gain as ordinary income creates additional compliance burdens whenever ordinary income is treated differently from capital gain, e.g., in the context of partnership distributions under section 751(b). Under our proposed option, section 291(a)(1) would either be repealed or would be amended to provide that any amount determined under section 291(a)(1) with respect to a corporate partner be carved-out from the exchange analysis.

15. Section 460: Extended Application of Home Construction Contract Exemption. Section 460(a) generally provides that taxable income from any long-term contract must be determined under the percentage of completion method. Because this method is not tied to actual receipt of payments, for many home developers it results in the recognition of

taxable income prior to the receipt of any cash. Section 460(e) provides an exemption for certain home construction contracts that allows such contracts to be accounted for under the completed contract method so that income is taken into account in the taxable year during which the contract is completed. While the home construction contract exemption specifically applies to townhomes and townhouses, it does not currently clearly apply to land and condominium developers and contractors. Under our proposed option, section 460(e) would be amended to clearly provide that the home construction contract exemption applies to land and condominium developers and contractors.

16. Section 465: At-Risk Rules Relating to Real Estate Activities. Section 465 limits the amount of losses individuals and certain closely held corporations may deduct with respect to certain activities, including real estate. Section 465 currently excludes nonrecourse debt secured by real property from a taxpayer's at-risk amount unless the lender is "actively and regularly engaged in the business" of lending money. Under our proposed option, section 465 would be modified to make it clear that amounts borrowed from entities such as investment trusts, single-purpose securitization vehicles and hedge funds that may not regularly make loans are nevertheless not precluded from being qualified persons. Section 465 also generally excludes nonrecourse seller financing secured by real property from a taxpayer's at-risk amount. Under our proposed option, the seller financing exclusion would not apply where the purchase money financing is extended by a bank or other similar lending institution in connection with the sale of real property that was acquired by the lender through foreclosure (or deed in lieu of foreclosure) of a loan made in the ordinary course of its trade or business because this type of seller financing should not present the risk of an inflated purchase price. Our proposed option would also relax this restriction where the seller financing is for not more than 85% of the purchase price being paid for the real property, provided the taxpayer provides equity for the 15% balance in the same taxable year as the sale.

17. Section 469(c)(7): Passive Activity Losses and Credits. Section 469 generally prevents a taxpayer from deducting a "passive activity loss," defined as the amount by which the taxpayer's aggregate losses from all passive activities exceed the taxpayer's aggregate income from all passive activities. Relief is granted under section 469(c)(7) for qualifying taxpayers, often referred to as "real estate professionals," who must apply the general material participation tests to determine whether a rental real estate activity is passive or active. However, in applying those tests, the qualifying taxpayer may not group a rental real estate activity with any other activity. We offer for your consideration the option of amending section 469 to override Regulation section 1.469-9 and allow qualified taxpayers to group all of their real estate activities together for purposes of determining whether such taxpayers have materially participated in their rental real estate activities.

18. Section 469(i) and (j)(5): Passive Loss Rules (Tax Credit Provisions). Section 469(i) allows individual taxpayers to deduct passive losses from rental real estate activities with active participation of up to \$25,000 each year (or \$9,900 credits, assuming a tax rate of 39.6%). This \$25,000 allowance is generally phased out completely for taxpayers with adjusted gross income ("AGI") of \$150,000, except that LIHTC investments under section 42 are exempt from the phase-out. LIHTC and qualified rehabilitation credits under section 47 are exempt from the active participation requirement. Under our proposed option, (i) the credit limitations for sections 42, 45D, 47 and 48 would be increased, (ii) the exemption from the \$150,000 AGI phase-out for section 42 credits would be expanded to include credits under sections 45D, 47 and 48 and (iii) the exemption from the active participation requirement would be extended to credits under sections 45D and 48.

19. Section 514(c)(9)(E): The "Fractions Rule."Section 514(c)(9)(E) provides an exemption to "qualified organizations" from unrelated business taxable income ("UBTI") for certain debt-financed real property investments that satisfy a number of requirements, including that the partnership's allocations have "substantial economic effect" under section 704(b) and also satisfy the so-called "fractions rule" contained in section 514(c)(9)(E). Under the fractions rule, a partner that is a qualified organization cannot be allocated an overall share of partnership income for any year that exceeds such partner's smallest percentage share of overall loss for any year on both a prospective and an actual basis for each taxable year of the partnership. Our proposed option would implement the Administration's 2011 proposal to replace the fractions rule with a rule that requires each partnership allocation to have substantial economic effect (as required by current law) and no allocation to have a principal purpose of tax avoidance.

20. Section 562(c): Preferential Dividends. A REIT is generally entitled to claim a deduction for dividends paid to its shareholders. However, the dividends paid deduction is not permitted for "preferential dividends," which are dividends that show a preference for shares of stock as compared with other shares of the same class, or a preference for one class of stock over another when the class is not entitled to such preference. REITs regularly encounter preferential dividend issues in circumstances where no abuse or tax avoidance motive is present. The RIC Modernization Act of 2010 repealed the preferential dividend rule for publicly traded regulated investment companies ("RICs"). The Administration's 2012 Budget proposed to repeal the rule for publicly traded REITs as well, and to provide Treasury with authority to cure inadvertent failures of the rule for other REITs. Our proposed option would repeal the rule for all

RICs and REITs, whether or not they are publicly traded.

21. Section 856(c): Qualifying Income for Timber REITs. REITs are required to satisfy a number of requirements in order to qualify as a REIT on an ongoing basis. One of those requirements is that its income satisfy two annual tests, a 75% gross income test and a 95% gross income test, designed to ensure that the REIT's income consists primarily of real estate and passive income. Section 856(c)(2)(I) temporarily treated mineral royalty income earned by a REIT that qualified as a "timber REIT" as qualifying income under the 95% gross income test, but this provision has now expired. Under our proposed option, the treatment of mineral royalty income as qualifying income of a REIT for purposes of the 95% gross income test would be made permanent, and would be extended to all REITs, regardless of whether they qualify as timber REITs. Our proposed option also contemplates that the now-expired rule under section 856(c)(5)(H), which temporarily treated certain gain from the disposition of timber under sections 631(a) and (b) as qualifying gain from the sale of real property for both the 75% and 95% gross income tests, would be reinstated and made permanent.

22. Section 856(c)(5)(G): Income from Hedging Transactions. Section 856(c)(5)(G) provides that income from certain hedging transactions is excluded from gross income for purposes of the 75% and 95% gross income tests. To qualify for the exclusion, the hedging transaction must be clearly identified pursuant to section 1221(a)(7), and the exclusion only applies to the extent the transaction hedges indebtedness incurred to acquire or carry real estate assets. This rule does not appear to extend to hedges that are entered into to offset prior qualifying hedging transactions that are no longer economically necessary but that may be too expensive to terminate. We offer for your consideration the option of expanding the exclusion to cover any hedge entered into primarily to offset a prior hedging transaction that qualified under the exclusion, and continuing to apply the exclusion to the pre-existing hedge.

23. Section 856(c)(4): Qualifying Real Estate Assets. Another requirement for REIT qualification is that, at the close of each quarter of a taxable year, at least 75% of a REIT's assets must consist of real estate assets, cash and cash items, and government securities. Although stock in other REITs qualifies as good "real estate assets" for these purposes, debt securities issued by REITs do not qualify unless they are secured by mortgages, which is often not the case. Under our proposed option, section 856(c)(5) would be amended to include debt securities issued by a public REIT or its subsidiary UPREIT partnership in the definition of "real estate assets," subject to the limitation that the total unsecured debt securities of one or more issuing REITs held by a particular investing REIT not constitute more than 25% of its total gross assets. In addition, under the qualifying income tests, rent attributable to personal property leased in connection with real property is treated as qualifying rental income as long as the rent attributable to the personal property does not exceed 15% of the total rent received under the lease for the taxable year. Our proposed option would also apply a similar rule for purposes of the asset test, which would provide that such personal property qualifies as a "real estate asset" so long as the value of the personal property does not exceed 15% of the total fair market value of the property subject to the lease. Finally, our proposed option would treat personal property securing a mortgage loan as a good real estate asset so long as the fair market value of such personal property does not exceed 15% of the total value of all the property securing the mortgage loan on the date the loan was originated or acquired by the REIT.

24. Section 856(d)(7): Impermissible Tenant Services Income. Under the 75% and 95% qualifying income tests, "rents from real property" include charges for services that are customarily furnished or rendered in connection with the rental of real property. However, "impermissible tenant services income," or "ITSI," which is generally defined as services that are not usually and customarily provided in connection with the rental of space for occupancy only, is not included as good rents from real property. Further, if the total value of nonqualifying services exceeds one percent of the total amounts derived from a property, all of the rents from that property will fail to qualify as good rents from real property. This rule can cause relatively minor services to cause rents from a particular property to fail to qualify as good income and can cause major qualification problems for a REIT. We offer as an option for your consideration that the one percent de minimis exception be increased to five percent.

25. Section 857(b)(6): Prohibited Transactions Tax. REITs are subject to a 100% confiscatory tax on net income from prohibited transactions, which are generally defined as sales of property by a REIT when it is acting as a dealer. The statute provides for certain safe harbors under which a REIT can sell property without risk of being subject to the tax. One of the safe harbors (the "ten percent safe harbor") applies if the aggregate adjusted bases or fair market values of the properties sold by the REIT during the taxable year do not exceed ten percent of the aggregate adjusted bases or fair market values, respectively, of all of the REIT's property at the beginning of the taxable year. In order to qualify under this safe harbor, all of the marketing and development expenditures with respect to the property sold must be made through an independent contractor from whom the REIT does not derive any income. This ten percent safe harbor is for many REITs the only safe harbor that they can reasonably hope to satisfy, and it is often far too restrictive in practice. Under our proposed option, the ten percent safe harbor would be modified so that a REIT can sell up to 20% of its properties, based on adjusted bases or fair market values, and so that a REIT can market its properties

through a taxable REIT subsidiary (a "TRS") or through an independent contractor. Our proposed option also includes the elimination of the requirement that development activities be conducted through an independent contractor, so that a REIT can conduct development activities either directly or through a TRS.

26. Section 857(d): REIT Earnings and Profits. Section 857(d) provides that a REIT's earnings and profits will not be reduced by amounts that are not allowable in computing its taxable income for a taxable year. This rule is intended to prevent the situation where a REIT does not have sufficient earnings and profits to carry out all of its taxable income as dividends because it incurred a cash outlay that is not deductible for tax purposes but that otherwise would have reduced earnings and profits. Read literally, however, this rule appears to apply also to REIT shareholders and can cause a shareholder to have dividend income from distributions that economically are a return of capital. Under our proposed option, section 857(d) would be amended to clarify that it applies only for purposes of calculating a REIT's dividends paid deduction and not for purposes of determining the taxability of distributions at the shareholder level.

27. Section 871(k): Interest-Related Dividends. Section 871(k) allows RICs to designate dividends to non-U.S. investors as "interest-related dividends," limited in amount to the RIC's qualified net interest income for such taxable year. This provision permits the tax characteristics of interest income earned by a RIC to flow through to its non-U.S. investors, thus permitting such dividends to be exempt from U.S. tax in many cases and encouraging foreign investment in RICs. The original provision expired at the end of 2007, and has been extended thrice, most recently through 2013. We offer for your consideration the option that REITs be permitted to make interest-related dividend designations with respect to their net interest income as well, and that section 871(k) be made permanent for both RICs and REITs.

28. Section 1031: The "Held For" Requirement. Section 1031(a) provides that a taxpayer recognizes no gain or loss on the exchange of property "held for productive use in a trade or business or for investment" solely for property of like kind "which is to be held either for productive use in a trade or business or for investment." The Service's position is that an exchange that is otherwise tax-free under section 1031 violates the "held for" requirement and, thus, is rendered fully taxable if the exchange transaction closely precedes or follows another tax-free transfer. The case law indicates that the held for requirement under section 1031(a) can and should be applied and satisfied by imputing the held for purpose to or from the exchanging taxpayer following or preceding an otherwise tax-free exchange. Moreover, it appears that, following its court losses, the Service is no longer litigating this issue. Consequently, we offer as an option that Congress codify the case law to clarify this area.

29. Section 1031: Inequitable Interaction with Sections 108 and 1017. Under Section 1017(a), if a taxpayer excludes cancellation of indebtedness income ("COD Income") from gross income under section 108, other than under section 108(c), an amount equal to such excluded income (subject to certain limitations) is applied to reduce basis of the property held by the taxpayer. If a taxpayer utilized the provisions of sections 108 and 1017 to exclude COD Income with respect to its raw land, such taxpayer would not be able to utilize section 1031 to defer recognition to the extent it attempted to exchange such property for other raw land, because such raw land replacement property could not be section 1245 property. The purpose of treating property that is neither section 1245 property nor section 1250 property as section 1245 property for recapture purposes is to ensure that at some point the excluded COD Income is recaptured. Since the purpose of the provision is not violated by a raw land for raw land exchange, our proposed option contemplates that the purpose of section 1245(b)(4) be modified to provide an exception for recapture in this type of situation.

30. Section 1033: Inequitable Interaction with Sections 108 and 1017. Under section 1017(a), if a taxpayer excludes COD Income from gross income under section 108, other than under section 108(c), an amount equal to such excluded income (subject to certain limitations) is applied to reduce basis of the property held by the taxpayer. If a taxpayer utilized the provisions of sections 108 and 1017 to exclude COD Income with respect to its raw land, such taxpayer would not be able to utilize section 1033 to defer recognition to the extent it attempted to replace the converted property with other raw land because such raw land replacement property could not be section 1245 property. The purpose of treating the property that is neither section 1245 property nor section 1250 property as section 1245 property for recapture purposes is to ensure that at some point the excluded COD Income is recaptured. Since the purpose of the provision is not violated by a raw land for raw land exchange, our proposed option contemplates that section 1245(b)(4) be modified to provide an exception for recapture in this type of situation.

Real Estate Legislation Simplification

I. Section ¹ 42(b)(2): Low-Income Housing Tax Credit

¹ References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise

indicated.

a. Present Law

The LIHTC may be claimed over a ten-year period (the "Credit Period") after each low-income building is placed-in-service. The amount of the credit for any taxable year in the Credit Period is the applicable percentage of the qualified basis of each qualified low-income building. The credit percentage for a low-income building is set for the earlier of: (1) the month the building is placed in service; or (2) at the election of the taxpayer, (a) the month the taxpayer and the housing credit agency enter into a binding agreement with respect to such building for a credit allocation, or (b) in the case of a tax-exempt bond-financed project for which no credit allocation is required, the month in which the tax-exempt bonds are issued. These credit percentages (used for the 70% credit and 30% credit) are adjusted monthly by the IRS on a discounted after-tax basis (assuming a 28% tax rate) based on the average of the Applicable Federal Rates for mid-term and long-term obligations for the month the building is placed in service. The discounting formula assumes that each credit is received on the last day of each year and that the present value is computed on the last day of the first year. In a project consisting of two or more buildings placed in service in different months, a separate credit percentage may apply to each building.

b. Reason for Change

There is a need for certainty in determining tax credit amounts throughout the project process. Our proposed option would simplify the determination of the applicable percentage by fixing the percentages at nine percent and four percent. The options for electing the credit percentage are replaced by a fixed, known percentage. Determination by the IRS of the applicable percentage based on the average of the Applicable Federal Rates is avoided. Separate credit percentages applying to multi-building projects are also avoided.

c. Option for Consideration

We offer for your consideration the option of amending section 42(b)(2) to provide an applicable percentage of nine percent for newly constructed non-Federally subsidized buildings placed in service after the date of enactment, and an applicable percentage of four percent for tax-exempt bond-financed projects placed in service after the date of enactment.

II. Section 42(i): Low-Income Housing Tax Credit

a. Present Law

The LIHTC is claimed annually over a Credit Period that begins when a building is placed in service or, at the irrevocable election of the taxpayer, in the succeeding taxable year. The low-income portion of a project must be maintained as such for 15 years, beginning with the commencement of the Credit Period (the "Compliance Period") or credits will be subject to recapture. A building will not be eligible for credits unless an "extended low-income housing commitment" is in effect with respect to the building. The commitment must provide for a restriction on evictions and rent increases which applies during the extended use period and continues for the three years following a termination of the commitment unless a tenant exercises a right of first refusal to purchase the project. The commitment must be to maintain as low-income units for 15 years after the end of the Compliance Period (or such later date specified in the commitment) the percentage of units specified in the commitment.

b. Reason for Change

The option that we offer for your consideration would bring both periods in line to the same timeframe allowing for more defined investor commitments without changing the total affordability period. The change would simplify the interaction between the Credit Period provisions and the Compliance Period provisions by providing a ten-year period for both. Issues involving the 2/3 accelerated credit recapture are avoided.

c. Option for Consideration

Our proposed option would establish a Compliance Period of ten taxable years beginning with the first taxable year of the Credit Period and extending the extended use period to 20 years after the close of the Compliance Period.

III. Section 42(g)(3): Low-Income Housing Tax Credit

a. Present Law

A “qualified low-income housing project” is a project for “residential rental property” that satisfies both a tenant-income requirement and a rent-restriction requirement under either of two minimum set aside tests: (a) 20-50 test - 20% or more of residential units are rent-restricted and occupied by individuals with income not more than 50% of area median gross income (“AMGI”); or (b) 40-60 test - 40% (25% in NYC) or more of residential units are rent-restricted and occupied by individuals whose income is not more than 60% of AMGI. Generally, the 20-50 or 40-60 tests must be satisfied by the end of the first year of the Credit Period and for the duration of the Compliance Period. If a building is part of a project consisting of multiple buildings, other buildings placed in service by the end of the first year of the first building's Credit Period and designated by the taxpayer may be taken into account for purposes of determining whether the 20-50 test or 40-60 test has been satisfied with respect to both the first building and the other buildings, provided that, in the aggregate, the other buildings and the first building satisfy those tests by the end of the first year of the first building's Credit Period. When determining the Credit Period and Compliance Period for the first building, the building is treated as placed in service on the most recent date that any other building elected for aggregation by the taxpayer was placed in service. A building (other than a “first” building) tested on an aggregate basis under a. above, may not be a qualified low-income building unless the remaining building or buildings in the project satisfy those tests without regard to such building.

b. Reason for Change

The Omnibus Budget Reconciliation Act of 1990 (the “1990 Act”) ² changed the testing date to the end of the first year of the Credit Period from the 12-month period following the date when the building was placed in service. The 1990 Act did not, however, make parallel changes to the provisions for multiple buildings. These provisions still refer to the 12-month period after the first building is placed in service as the time limit for aggregating other buildings with the first building for purposes of satisfying the qualification tests. Our proposed option would simplify the multiple building set-aside test by providing that minimum set aside for the entire project must be met no later than the close of the second year of the Credit Period. The provisions for relying on later buildings for qualification are avoided.

² Pub. L. No. 101-508, 104 stat. 1388.

c. Option for Consideration

Our proposed option would provide that a building will be treated as a qualified low-income building only if the project (of which such building is a part) meets the requirements of the minimum set aside test not later than the close of the second year of the Credit Period for such building.

IV. Section 42(g)(7): Low-Income Housing Tax Credit

a. Present Law

Pursuant to Regulation section 1.103-8(b), multiple buildings may be treated as part of a single project if they contain similarly constructed units and are owned by the same person, located on the same or contiguous parcels of real estate and financed pursuant to a common plan. However, buildings that could not be treated as a single project because of their lack of proximity may be so treated if all of the units in each building are rent restricted.

b. Reason for Change

Our proposed option would simplify the development of mixed-income scattered-site LIHTC projects by removing the requirement that all of the units in each building be rent restricted.

c. Option for Consideration

Our proposed option would provide that buildings which would (but for their lack of proximity) be treated as a project for purposes of section 103 shall be so treated for purposes of section 42(g)(7) if all the buildings are owned by the same person and financed pursuant to a common plan.

V. Section 42(j)(4)(E): Low-Income Housing Tax Credit

a. Present Law

If as of the close of any taxable year in the Compliance Period, the amount of the qualified basis of any building with respect to the taxpayer is less than the amount of such basis as of the close of the preceding taxable year, then the

taxpayer's tax for the taxable year shall be increased by the credit recapture amount. Recapture does not apply to a reduction in qualified basis by reason of a casualty loss to the extent such loss is restored by reconstruction or replacement within a reasonable period established by the Secretary. If the loss is not restored prior to the year-end in which the loss occurs, the tax credits for the units out of service will be lost during the restoration of the property.

b. Reason for Change

Our proposed option would simplify the casualty loss recapture rule by fixing, and providing certainty to, the time period to repair and place-in-service a unit damaged by a casualty loss.

c. Option for Consideration

Our proposed option would provide that a recapture shall not apply to a reduction in qualified basis by reason of a casualty loss to the extent such loss is restored by reconstruction or replacement within six months regardless of which tax year the loss is restored.

VI. Section 47: Historic Tax Credit

a. Present Law

There is considerable uncertainty as to whether an investor that is admitted to a partnership either owning an historic project eligible for historic tax credits or leasing such project from the owner in the case of a project utilizing a lease pass-through election must earn a "market" rate of return with respect to its investment without taking into account the historic tax credits that will be allocated to the investor. Typically, an investor would be asked to make a capital contribution equal to between 80% and 90% of the amount of historic tax credits that would be allocated to the investor with respect to its partnership interest. The allocation of those tax credits, without any further economic benefits to the investor, would allow the investor to realize a positive rate of return on its investment without receiving annual distributions of net cash flow from the project and without sharing in net sales proceeds from a disposition of the project by the partnership. However, there is considerable uncertainty as to whether the investor would be treated as a partner in the partnership for tax purposes, whether a 99% profit allocation to the partner would be respected, or whether other tax principles might be applied (including but not limited to business purpose) to deny the investor the ability to claim the historic tax credits that are allocated to it. *Sacks v. Commissioner*, 69 F3d 982 (9th Cir. 1995), stands for the proposition that the utilization of tax credits in a manner consistent with Congressional intent should be taken into account in determining the intention of an investor to earn a positive return with respect to its investment.

b. Reason for Change

The tax credit industry does not find the *Sacks* case by itself to be authoritative and accordingly structures transactions so that the tax credit investor also receives an annual "cash on cash" return of between two percent and three percent each year and has the right to receive some fraction of its original investment as a return of capital after the five-year tax credit recapture period (often in the neighborhood of 20%). As a consequence of receiving these economic benefits, the tax credit investor obligates itself to contribute additional capital so that its overall return on its investment will be the same as if it had made a smaller capital contribution and received only the tax benefits as a return. Often investors explain the need to show an economic return apart from the tax credits in historic tax credit transactions by noting that in the case of the LIHTC under section 42, Regulation section 1.42-4 specifically states (or attempts to state) that the "not-for-profit" rules of section 183 will not apply to the LIHTC. No similar regulation applies to historic tax credits. Moreover, Regulation section 1.42-4 is flawed in the sense that section 183 does not apply to corporate investors who make up the vast majority of investors in both LIHTC and historic tax credit projects, and Regulation section 1.42-4(b) limits the relief by stating that the availability of credits may still be limited or disallowed under other provisions of the Code or principles of tax law including sham transaction, economic substance or ownership analysis. Our proposed option would allow the developers of the historic tax credit projects and tax credit investors to more efficiently utilize the tax credit subsidy by permitting them to structure the investment of the tax credit investor in a way that is more naturally based upon their business arrangement, i.e., that the amount of capital contributed by the tax credit investor will be set at a level which will provide it with a "market" rate of return based entirely upon the receipt of the historic tax credits.

c. Option for Consideration

We offer as an option for your consideration that Congress codify the position of the Ninth Circuit in the *Sacks* case that a tax credit investor that receives a "market" rate of return with respect to its investment when taking into account

the value of the historic tax credits that it is allocated will be treated as a partner in a partnership that owns the qualified rehabilitation expenditures with respect to an historic tax credit project without regard to the net cash distributions that it may be entitled to receive or its share of net sale proceeds.

VII. Section 47: Historic Tax Credit

a. Present Law

The rules under section 47 include specific procedures and timetables for the rehabilitation of certified historic structures and generally require that certain minimum rehabilitation expenditures be incurred during a 24-month measuring period. One condition to claiming historic tax credits is that the qualified rehabilitation expenditures equal or exceed the adjusted tax basis of the structure at the beginning of the 24-month measuring period, ensuring that eligible projects involve substantial rehabilitation. Section 47 provides that at the end of the rehabilitation of a certified historic structure a filing must be made with the National Park Service that confirms that the rehabilitation of the structure has been completed in accordance with the plans previously submitted to and approved by the National Park Service (the "Part 3 Approval"). There are additional rules under section 47 that apply to phased rehabilitations the effect of which is to extend the 24-month period to a 60-month period where it is anticipated that a structure will be rehabilitated in multiple phases over a longer period of time.

b. Reason for Change

These rules work reasonably well in a situation in which the entire structure is owned by the same taxpayer and the rehabilitation of the structure will occur on a continuous basis from start to finish, albeit over a longer period of time. What these rules do not adequately address, however, is the more common fact pattern in which a large certified historic structure will be divided into separate condominium units under local real estate law, with different taxpayers owning the different units, and with only loose coordination among the owners as to the timing of the rehabilitation of the separate condominium units. In these instances, section 48 (and the regulations promulgated thereunder) provides that the overall structure is a single "cultural resource" and that the Part 3 Approval will not be granted until all of the rehabilitation work with respect to the entire structure is completed. The effect of this approach is that the taxpayer who completes the earliest rehabilitation of a phase will have a difficult time predicting when it will be entitled to its Part 3 Approval, while a taxpayer owning a different condominium unit in the same structure may find that it is not eligible for historic tax credits unless it can complete its rehabilitation within a period of approximately 60-months after the commencement of the rehabilitation by the first taxpayer. The rehabilitation of certain large certified historic structures that must be developed in multiple phases, particularly where the development of certain portions of the structure may not be commercially viable until after the completion of the rehabilitation of other components of the structure, is being impeded by the current rules under section 47. Our proposed option would clarify section 47 by treating different condominium units within an overall structure as separate buildings for purposes of the historic tax credit, provided that the condominium documents include mutual covenants among the condominium owners that all rehabilitation work will be performed in accordance with the standards of the National Park Service. Our proposed option would also provide needed flexibility that would encourage the redevelopment of such structures without undermining the policy in favor of ensuring that the rehabilitation of the structure is done entirely in accordance with the National Park Service standards.

c. Option for Consideration

Under our proposed option, the definition of a certified historic structure for purposes of section 47 would be expanded to include any separately deedable interest in real estate with respect to a building including condominium units or similar estates, provided that the condominium documents or comparable documents for other forms of ownership contain an irrevocable covenant of all of the co-owners that any and all rehabilitation expenditures made with respect to any portion of the structure must be made in accordance with the standards of the National Park Service.

VIII. Section 50(d): Historic Tax Credit

a. Present Law

The historic rehabilitation tax credit under sections 46(1) and 47 generally provides that the tax credit is available to the owner for Federal income tax purposes of qualified rehabilitation expenditures that are incurred in connection with the rehabilitation of a certified historic structure (or qualified rehabilitated building other than a certified historic structure in the event of the ten percent tax credit). However, over the past decade the most common structure for a historic tax credit transaction involves the owner of the structure leasing the entire structure to a separate entity and making an election to pass the historic tax credit through from the lessor to the lessee. The historic tax credits are "syndicated" by

admitting into the lessee entity a tax credit investor that makes a significant capital contribution to that entity. This structure is based entirely upon a reference in section 50(d)(5) which states: For purposes of this subpart, rules similar to the rules of the following provisions (as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990) shall apply: (v) Section 48(d) (relating to certain leased property).

b. Reason for Change

The basis for the current tax credit syndication market is a provision no longer included in the Code but preserved as it existed more than 20 years ago, at a time when the provision had much more limited application and had received far less use and scrutiny. Our proposed option would incorporate directly into section 47 the operative provisions pertaining to the master lease or lease pass-through election that could be made by a lessor to a lessee with respect to a historic tax credit project. The authority for utilizing the lease pass-through election would be clarified and the specific conditions that are imposed in connection with the election could be detailed in a way that would significantly reduce the uncertainty and resulting transaction costs.

c. Option for Consideration

Our proposed option contemplates that a new subsection 47(e) entitled "Lease Pass-through Election" would be added to section 47. This new subsection would incorporate the rules formerly contained in section 48(d), including the net lease rules, the recognition of phantom income by the lessee, and the provisions requiring that the lessor qualify in its own right for the historic tax credits as a condition to being able to elect to pass the historic tax credits through to a lessee. In addition, this new subsection 47(e) would address the efficacy of certain common techniques for the transfer of funds received by the lessee as a capital contribution from the tax credit investor to the lessor which is incurring the qualified rehabilitation expenditures, including structures in which the lessee owns a minority partnership interest in the lessor.

IX. Section 108: Income From Discharge Of Indebtedness

a. Present Law

Gross income includes income from the discharge of indebtedness or cancellation of debt ("COD Income"). COD Income occurs when a debt is forgiven or cancelled, or when a creditor accepts payment of less than the unpaid balance in complete satisfaction thereof. The amount of income generally equals the excess of the adjusted issue price of the obligation being cancelled over the amount of consideration paid in complete settlement thereof. Recognizing that most discharges occur when debtors are facing financial difficulties and are least able to pay tax, Congress enacted section 108 in the Bankruptcy Tax Act of 1980³. To preserve a financially troubled debtor's "fresh start" after a debt discharge, section 108 provides that COD Income realized by taxpayers in a Title 11 case or who are insolvent (or other taxpayers with respect to certain types of qualifying indebtedness) is excluded from gross income. While the COD Income is excluded, the taxpayer's tax attributes – largely loss carryovers and the bases of property – are reduced by the amount so excluded. Any excluded income in excess of tax attributes is permanently excluded from the taxpayer's gross income. Section 108 also provides other "stand-alone" rules governing COD Income, including exceptions from recognition where payment of the debt would have given rise to a deduction⁴ and where the debt arose out of the purchase of the property.⁵

³ Pub. L. No. 96-589, 94 Stat. 3389.

⁴ I.R.C. §108(e)(2).

⁵ I.R.C. §108(e)(5).

b. Reason for Change

When section 108 was enacted in 1980, it represented a codification of numerous statutory and judicial rules developed over 50 years. It was comprehensive and achieved an optimal balance between the debtor's interest of achieving a financial "fresh start" and the government's interest in deferral and eventual collection of tax through the reduction of a debtor's tax attributes. Thus, to the extent there was an eventual economic gain, the tax would ultimately be collected in subsequent tax years when the debtor had the financial ability to pay. It also codified many specific rules, including those for lost deductions, purchase money debt reductions and the equity for debt exception. Subsequent changes to section 108 intended to narrow the application of this "optimal" regime brought about serious adverse consequences for troubled debtors and have created needless obstacles, complexity and impediments to the ability of debtors and creditors to "work out" troubled debt in an economic manner without the imposition of an

immediate tax liability. Thus, the repeal of the qualified business indebtedness exception in 1986, the repeal of the equity for debt exception in 1993, the narrowing of the definition of the insolvency exception and the repeal of the deduction for personal interest have created a “perfect storm” of problems and obstacles for debtors and creditors seeking to “work out” troubled debt. Even a special rule for the treatment of qualified principal residence debt had to be enacted to deal with the housing crisis in 2007, in part, because of the inherent mismatch: while any debt reduction was taxable income, any loss on disposition was not deductible. In addition, the result of adding exempt assets back into the insolvency calculation causes the exact opposite result to that initially intended by enactment of the insolvency exception that was to prevent people from being forced to file for bankruptcy protection in order to avail themselves of the exemption. The insolvency exception originally was adopted to allow taxpayers to get relief without having to file for bankruptcy protection. Our proposed option would allow for a return to the optimal statutory regime as originally enacted.

c. Option for Consideration

The option that we offer for your consideration contemplates that all of the provisions of section 108, as originally enacted in 1980, be returned. It was an optimal statutory regime that addressed most debt workout situations and provided for an appropriate balance and result from the perspectives of both the taxpayer and the government. This would include the re-enactment of the qualified business debt exception (allowing all business taxpayers to elect to reduce the basis of depreciable property in lieu of current recognition of COD Income from business indebtedness) and the equity for debt exception for corporations and partnerships. It should also include the addition of special rules to solve vexing current issues: making the qualified principal residence indebtedness exception permanent; treating personal interest “as if” deductible for purposes of section 108(e)(2); excluding retirement and other assets exempt from creditors under the taxpayer’s applicable state law from being counted as an “asset” in the insolvency calculation; and clarifying that partners should be able to claim their share of partnership debt in their personal insolvency calculation (and if nonrecourse debt, where it is the subject nonrecourse debt that is being reduced). If section 108 cannot be re-enacted in its original form, then we offer as an alternative option additional changes to existing section 108 as follows:

(1) Section 108(a)(1)(D) qualified real property business indebtedness exception:

Clarify that real estate investment trusts are eligible for the election, and are not excluded because they are technically taxable as a C corporation.

Clarify and broaden the “secured by” requirement in section 108(c)(3)(A), so it allows for and accommodates current financing techniques and structures.⁶

⁶See PLR 200953005 (Sept. 23, 2009).

Clarify that partial elections are permitted under section 108(c)(3)(C).

Clarify that the term “qualified real property business indebtedness” includes dealer property and property held for one year or less.

(2) Clarify that section 108(e)(6) applies to partnerships, so that the forgiveness of a debt owed to a creditor is treated as a nontaxable contribution to capital to the extent of the creditor’s adjusted basis in the debt.

X. Section 110: Qualified Lease Construction Allowances

a. Present Law

Section 110 was enacted in 1997 to provide lessees of real property a safe harbor for “qualified lessee construction allowances” for short-term leases.⁷ Under section 110(a), the lessee has no gross income from funds received from the lessor in cash (or treated as a rent reduction):

⁷ Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788, §1213(a), applicable to leases entered into after August 5, 1997, pursuant to *I.R.C. §1213(e)*.

(1) under a short-term lease of retail space; (2) for the purpose of such lessee’s constructing or improving qualified long-term real property for use in such lessee’s trade or business at such retail space; but (3) only to the extent that such amount does not exceed the amount expended by the lessee for such construction or improvement. Consistent treatment by the lessor is required under section 110(b), under which qualified long-term real property constructed or

improved in connection with any amount excluded from a lessee's income under section 110(a) is treated as nonresidential real property of the lessor, including for purposes of section 168(i)(8)(B). For purposes of section 110, "qualified long-term real property" is defined as nonresidential real property which is part of, or otherwise present at, the retail space referred to in section 110(a) and which reverts to the lessor at the termination of the lease. A "short-term lease" is a lease (or other agreement for occupancy or use) of retail space for 15 years or less, generally including options to renew other than at then fair market rental value, as determined under the rules of section 168(i)(3). "Retail space" means real property leased, occupied, or otherwise used by a lessee in its trade or business of selling tangible personal property or services to the general public.⁸ Under section 110(d), the Department of the Treasury ("Treasury") is authorized and directed to issue regulations requiring the lessee and lessor to provide (1) information concerning the amounts received (or treated as a rent reduction) and expended as described in section 110(a), and (2) any other information that the Secretary deems necessary to carry out the provisions of section 110(a).

⁸See I.R.C. §110(c).

The regulations under section 110,⁹ effective for leases entered into on or after October 5, 2000, generally follow the statute. However, Regulation section 1.110-1(b)(3) adds a "purpose requirement" that reads in full as follows: An amount will meet the requirement [of Regulation section 1.110-1(b)(1)(ii)] only to the extent that the lease agreement for the retail space expressly provides that the construction allowance is for the purpose of constructing or improving qualified long-term real property for use in the lessee's trade or business at the retail space. An ancillary agreement between the lessor and the lessee providing for a construction allowance, executed contemporaneously with the lease or during the term of the lease, is considered a provision of the lease agreement for purposes of the preceding sentence, provided the agreement is executed before payment of the construction allowance. Consistent treatment by the lessor is required under Regulation section 1.110-1(b)(5), which reads in full as follows: Qualified long-term real property constructed or improved with any amount excluded from a lessee's gross income by reason of [Regulation section 1.110-1(a)] must be treated as nonresidential real property owned by the lessor (for purposes of depreciation under [section] 168(e)(2)(B) and determining gain or loss under [section] 168(i)(8)(B)). For purposes of the preceding sentence, the lessor must treat the construction allowance as fully expended in the manner required by [Regulation section 1.110-1(b)(1)(iii)] unless the lessor is notified by the lessee in writing to the contrary. General tax principles apply for purposes of determining when the lessor may begin depreciation of its nonresidential real property. The lessee's exclusion from gross income under [Regulation section 1.110-1(a)], however, is not dependent upon the lessor's treatment of the property as nonresidential real property.

⁹T.D. 8901, 2000-2 C.B. 272.

b. Reason for Change

The purpose language required under Regulation section 1.110-1(b)(3) is quite specific and, for lessees unfamiliar with the regulations under section 110, may well not be included in a lease, either as originally drafted or through an amendment executed before payment of the construction allowance. The requirement under Regulation section 1.110-1(b)(5) that the lessor claim depreciation deductions for the cost of the leasehold improvements is intended to avoid the lessor and lessee reporting inconsistently. Thus, it appears that the purpose language required under Regulation section 1.110-1(b)(3), the purpose of which is addressed by the consistency requirement under Regulation section 1.110-1(b)(5), is often a trap for the unwary. Our proposed option would help to resolve any potential confusion for taxpayers.

c. Option for Consideration

Our proposed option contemplates that Congress will amend section 110 to expressly provide that, for purposes of "qualified lessee construction allowances" for short-term leases, the lease agreement for the retail space is not required to include an express statement that the construction allowance is for the purpose of constructing or improving qualified long-term real property for use in the lessee's trade or business at the retail space.

XI. Section 167: Depreciation/Section 168: Accelerated Cost Recovery System

a. Present Law

Section 167 provides as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property used in a trade or business or property held for production of income. The depreciation deduction provided by section 167 for tangible property generally is determined under section 168. Section 168 generally provides for depreciation deductions under the modified accelerated cost recovery system (MACRS) for tangible property placed in service after December 31, 1986. The applicable recovery period of

tangible property denoting the period of the depreciation is determined by the property's class life or as specifically provided by statute. Nonresidential real property generally is depreciated using the straight-line method over a 39-year recovery period. Residential rental property generally is depreciated using the straight-line method over a 27.5-year recovery period. Qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property placed in service before January 1, 2012, generally are depreciated using the straight-line method over a 15-year recovery period; however, qualified leasehold improvement property and qualified restaurant property may be eligible for bonus depreciation. Land improvements, such as parking lots, sidewalks, roads, landscaping and fences, generally are depreciated over a 15-year recovery period, while most other tangible personal property not part of the building or structure (e.g., furniture and equipment) generally is depreciated over a five- or seven-year recovery period.

b. Reason for Change

The applicable recovery period of tangible property should reflect the economic useful life of such property. A current review and comprehensive study of the applicable recovery periods for real estate assets are important and timely. The Congressional Research Service, CRS Issue Brief for Congress entitled "Depreciation and the Taxation of Real Estate," dated May 5, 1999 (the "1999 CRS Report"), concludes that real estate structures appear to be overtaxed relative to equipment. In addition, the comprehensive study entitled "Report to The Congress on Depreciation Recovery Periods and Methods" submitted by Treasury to the House Committee on Ways and Means and the Senate Finance Committee on July 28, 2000 (the "2000 Study"), suggests that addressing the determination of the appropriate recovery periods for real estate assets could improve the functioning of the current depreciation system. A comprehensive study of the applicable recovery periods of depreciable real estate should be undertaken by the government to update and supplement the 2000 Study.

The economic useful life of real estate assets (or specific types of real estate assets) may generally change over time resulting in the depreciable recovery periods not being reflective of economic realities. The current applicable recovery periods may not adequately track and reflect changes that have occurred in the real estate industry and may overstate an asset's economic useful life. For example, the 39-year recovery period for nonresidential real property (e.g., commercial buildings and structures) has been the applicable recovery period for this type of property placed in service after May 13, 1993, and is the longest recovery period for this type of property in several decades. Prior to the adoption of MACRS, the accelerated cost recovery system (ACRS) generally provided a shorter 19-year recovery period for buildings (and their structural components). Upon the adoption of MACRS, nonresidential real property was initially assigned a 31.5-year recovery period, which was subsequently increased to the current 39-year recovery period for property placed in service after May 13, 1993, without any supporting evidence or data for such subsequent increase cited in the legislative history. The 2000 Study suggests that, based on empirical evidence, the 39-year recovery period for nonresidential buildings may be slow relative to economic depreciation and that additional analysis and investigation is required. Furthermore, the 1999 CRS Report suggests that shortening the recovery period for structures to around 20 years would equalize the effective tax rates among structures and equipment and restore equal tax treatment among these assets. The prior 19-year recovery period may be a more accurate reflection of the economic useful life for nonresidential buildings. The general rule of a 39-year recovery period for nonresidential real property and a 27.5-year recovery period for residential rental property may overstate the economic useful life of the underlying property. Additional classes of depreciable real estate assets may need to be considered and established or extended. Considerable differences in the recovery period of buildings (and their structural components) may exist depending on their characteristics and use. For example, property classified as qualified leasehold improvement property, qualified restaurant property or qualified retail improvement property placed in service before January 1, 2012, generally has a recovery period of 15 years rather than the 39-year recovery period generally allowed for nonresidential real property. However, these shorter recovery periods are scheduled to cease for property placed in service on or after January 1, 2012, and may need to be extended and further adjusted to adequately reflect the economic useful life of these types of assets. Additionally, significant differences in the recovery periods of buildings (and their structural components) and the recovery periods of personal property not considered part of the building or structure exist. Thus, many taxpayers implement cost segregation to distinguish the property treated as structural components from the items treated as personal property. This distinction is not always clear and can be costly and burdensome to both the Internal Revenue Service (the "Service") and taxpayers. The ambiguity and complexity in making these distinctions generally require the employment of engineers, architects and other construction experts, and in addition, generally lead to an increased administrative burden to the Service and taxpayers, potential disputes between the Service and taxpayers and potential differing results among taxpayers. In connection with a comprehensive study of the applicable recovery periods of real estate assets, these cost segregation issues should be taken into account.

Depreciation and the cost recovery of real estate have a significant impact on the tax benefits and burdens of real

estate and the investment in real estate. The potential variance between an asset's economic useful life and depreciable recovery period ultimately results in a higher effective tax rate for the taxpayer and may negatively impact investments in real estate. Therefore, it is important that the applicable recovery periods of real estate assets be revisited from time to time to enable them to stay current and to reasonably reflect the current economic realities.

c. Option for Consideration

Our proposed option contemplates that a comprehensive study of the recovery periods of depreciable real estate be undertaken to determine and ensure that the applicable recovery periods for these assets are reflective of the economic useful lives of such assets. Upon completion of this study, our proposed option further contemplates that Congress would enact statutory depreciation periods for real estate that are consistent with the study.

XII. Section 179D(d)(4): Energy Efficient Commercial Building Property Deduction

a. Present Law

Section 179D provides a deduction for part or all of the cost of energy efficient commercial building property that a taxpayer places in service after December 31, 2005, and before January 1, 2014. Section 179D(d)(4) provides that in the case of energy efficient commercial building property that is installed on or in property owned by a Federal, State, or local government or a political subdivision thereof, the Secretary shall promulgate a regulation to allow the allocation of the section 179D deduction "to the person primarily responsible for designing the property [the designer] in lieu of the owner of such property." A designer is a person that creates the technical specifications for installation of energy efficient commercial building property for which a deduction is allowed under section 179D. The section 179D deduction will be allowed to the designer for the taxable year that includes the date on which the property is placed in service. A designer may not claim a section 179D deduction in excess of the amount of the costs incurred by the owner of the government-owned building to place the energy efficient commercial building property in service. The designer does not include any amount in income on account of the section 179D deduction allocated to the designer and the designer is not required to reduce future deductions by an amount equal to the section 179D deduction allocated to the designer.¹⁰

¹⁰See Notice 2008-40, 2008-2 C.B. 166, for further rules regarding the allocation provision of section 179D(d)(4).

b. Reason for Change

Many of the designers that receive allocations of the section 179D deduction under section 179D(d)(4) are organized as partnerships or S corporations for federal tax purposes. These firms often distribute the majority of their net income to their partners or shareholders at the end of each taxable year, as architectural and design firms typically require minimal capital to operate. This practice results in the partners and shareholders having minimal bases in their ownership interests in the designer entities. If the government entity allocates a deduction to the designer pursuant to section 179D(d)(4), it is the partnership or S corporation that receives the allocation of the section 179D deduction allocation. Although certain deductions of a partnership or S corporation may be claimed directly by its partners or shareholders, in those instances there exists explicit authority providing for such a result. For example, section 199(d)(1) specifically provides that, with respect to partnerships and S corporations, the deduction available under that section applies "at the partner or shareholder level." However, no such language exists with respect to the deduction allowed under section 179D. Absent such authority, the deduction under section 179D, like any other partnership or S corporation item of deduction, is used to calculate the entity's ordinary income or loss. Each partner's or shareholder's share of that income or loss requires an adjustment to the partner's or shareholder's tax basis in his ownership interests under section 705(a) or 1367(a), and the partner's or shareholder's ability to claim any ordinary loss generated by the deduction is limited to the tax basis in his ownership interest under section 704(d) or section 1366(d). Accordingly, even though it was the intention of Congress to provide a tax benefit to designers of energy efficient buildings, the actual operation of section 179D(d)(4) may result in no tax benefit to designers and architects operating through partnerships or S corporations.

c. Option for Consideration

Our proposed option for resolving the partnership and S corporation basis mismatch created by section 179D is to treat the amount of the section 179D(d)(4) deduction that is assigned to a partnership or S corporation and allocated to its partners or shareholders as being equivalent to income earned by the partnership or S corporation that is exempt from tax. If the income otherwise shielded from tax by the section 179D(d)(4) deduction were in fact classified as income exempt from tax to the partnership or S corporation to which the deduction is allocated, the partners or shareholders

should be entitled to receive a basis increase under section 705 (in the case of a partnership) or section 1367(a)(1)(A) (in the case of an S corporation) to the extent of the untaxed income. This treatment would then enable the partnership or S corporation to distribute the accumulated income for the year to the partners or shareholders without exposing them to additional tax. Therefore, our proposed option contemplates that the following language be added to the last sentence of section 179D(d)(4): “and shall be treated as receiving income exempt from tax under this title.”

XIII. Section 267: Sales Between Partnerships and a Related Nonpartner or Between Two Partnerships

a. Present Law

Sales between partnerships and nonpartners or between two partnerships that are not subject to section 707(b) may nevertheless be subject to section 267 pursuant to Regulation section 1.267(b)-1(b)(1) (the “Section 267 Proportional Disallowance Regulations”), which provides that: “[a]ny transaction described in section 267(a) between a partnership and a person other than a partner shall be considered as occurring between the other person and the members of the partnership separately. Therefore, if the other person and a partner are within any one of the relationships specified in section 267(b), no deductions with respect to such transactions between the other person and the partnership shall be allowed - (i) To the related partner to the extent of his distributive share of the partnership deductions for the losses ... , and (ii) To the other person to the extent the related partner acquired an interest in any property sold to or exchanged with the partnership by such other person at a loss.... The Section 267 Proportional Disallowance Regulations do not reflect the 1982 addition of section 267(b)(10), which disallowed in its entirety losses on sales between a corporation and partnership where the same persons own directly or indirectly more than 50% of the value of the corporation and more than 50% of the capital or profits of the partnership, nor the 1986 amendment to section 707(b)(1)(A), which disallowed in its entirety losses on sales between partnerships and controlling persons who own directly or indirectly more than 50% of the capital or profits interests of the partnership. In the 1986 amendment to section 707(b), the Senate Report indicated that section 707(b) was to exclusively govern sales between partnerships.¹¹ The Service, however, takes the position that the Section 267 Proportional Disallowance Regulations survive, except to the extent that each of sections 267(b)(10) and 707(b)(1)(A) specifically override it.

¹¹S. Rep. No. 313, 99th Cong., 2d Sess. 980 (1986).

b. Reason for Change

Applying section 267 on an aggregate basis to transactions between the partners of two partnerships or the partners of a partnership and a nonpartner treats some transactions more harshly than transactions directly between a partner and a partnership. For example, if a partnership sells property at a loss to the spouse of a ten percent partner, the Section 267 Proportional Disallowance Regulations preclude the partner's recognition of his ten percent distributive share of partnership loss on the sale. On the other hand, if the partnership sells the property to the partner, neither section 267 nor section 707(b) applies because the partner owns less than 50% of the capital or profits in the partnership and is therefore not related to the person acquiring the property.

c. Option for Consideration

Our proposed option contemplates that Congress indicate in legislation that section 707(b) specifically overrides the Section 267 Proportional Disallowance Regulations.

XIV. Section 291(a)(1): Special Rules Relating to Corporate Preference Items

a. Present Law

Congress enacted section 291(a)(1) as part of the Tax Equity and Fiscal Responsibility Act of 1982¹² effective for dispositions after December 31, 1982. Section 291(a)(1) recharacterizes a portion of a corporation's capital gain on the disposition of section 1250 property as ordinary income. Specifically, the statute provides that when a corporation disposes of any section 1250 property, it must treat as ordinary income 20% of the difference between the amount that would be subject to recapture if the property had been subject to section 1245 and not section 1250 and the amount recaptured under section 1250.

¹² 97 P.L. 248, section 204(a)

b. Reason for Change

When Congress enacted section 291(a)(1), the highest marginal income tax rate on a corporation's ordinary income

was 46% while the maximum capital gains rate was 28%. Thus, recharacterizing a portion of a corporation's capital gain on its sale of section 1250 property as ordinary income increased the amount of the corporation's income tax payable on the disposition. Currently, a corporation does not have separate rate schedules for capital gain and ordinary income. Nevertheless, the recharacterization of capital gain as ordinary income creates additional compliance burdens whenever ordinary income is treated differently from capital gain without any increased tax burden. This additional complexity can be seen in section 751 when a partnership is owned by both corporate and non-corporate partners. For example, if a corporation sold its interest in the partnership that corporate partner would have to report under section 751(a) its share of the partnership's gain that, if the corporate partner owned the property directly, would be described in section 291(a)(1), even though the corporation's overall tax due would not change. Finally, this disparity in treatment could cause a problem upon a distribution to a partnership that has both corporate and non-corporate partners. When measuring whether there has been an exchange under section 751(b), a corporate partner could be viewed as exchanging an interest in ordinary income property due to the recharacterization rule of section 291(a). In that instance, section 751(b) could trigger exchange treatment between the corporate partner and the non-corporate partner even though the partnership never held any section 751 property with respect to the non-corporate partner.

c. Option for Consideration

Our proposed option contemplates that Congress would eliminate section 291(a)(1) or, at a minimum, specifically provide that any amount determined under section 291(a)(1) with respect to a corporate partner be carved-out from the exchange analysis under section 751(b) when a partnership has both corporate and non-corporate partners.

XV. Section 460: Extended Application of Home Construction Contract Exemption

a. Present Law

Section 460(a) generally provides that taxable income from any long-term contract must be determined under the percentage of completion method as set forth in section 460(b). For purposes of section 460(a), a long-term contract is "any contract for the manufacture, building, installation, or construction of property if such contract is not completed within the taxable year in which such contract is entered into." In general, under the percentage of completion method, net income is reported over the term of the long-term contract based on a ratio of costs incurred over total estimated costs to be incurred in connection with the contract. As a result, this method of accounting is not tied to actual receipt of payments on a contract and, for many home developers, results in the recognition of taxable income prior to the receipt of any cash that could be utilized by the developer to pay the tax attributable to such income. Section 460(e) provides an exception to the application of the percentage of completion method for certain construction contracts (the "Home Construction Contract Exemption"). Specifically, section 460(e)(1) provides that the required application of the percentage of completion method set forth in section 460(a) does not apply to any "home construction contract" and the regulations under section 460 provide that a taxpayer may use the completed contract method for a home construction contract. Generally, under the completed contract method, a taxpayer takes into account income from a construction contract in the taxable year during which the contract is completed. Section 460(e)(6) provides that, for purposes of section 460(e): The term "home construction contract" means any construction contract if 80% of the estimated total contract costs (as of the close of the taxable year in which the contract was entered into) are reasonably expected to be attributable to [the building, construction, reconstruction, or rehabilitation of, or the installation of any integral component to, or improvement of, real property] with respect to – (i) dwelling units (as defined in section 168(e)(2)(A)(ii)) contained in buildings containing 4 or fewer dwelling units (as so defined), and (ii) improvements to real property directly related to such dwelling units and located on the site of such dwelling units. For purposes of clause (i), each townhouse or rowhouse shall be treated as a separate building.¹³

¹³ I.R.C. §168(e)(2)(A)(ii)(I) provides that "the term 'dwelling unit' means a house or apartment used to provide living accommodations in a building or structure, but does not include a unit in a hotel, motel, or other establishment more than one-half of the units in which are used on a transient basis."

b. Reason for Change

On August 4, 2008, Treasury and the Service published a notice of proposed rulemaking in the Federal Register¹⁴ containing proposed regulations (the "Proposed Regulations") relating to the Home Construction Contract Exemption. The Proposed Regulations provide that a long-term construction contract is a home construction contract if 80% of a taxpayer's (including a subcontractor working for a general contractor) estimated total contract costs are reasonably expected to be attributable to construction activities with respect to dwelling units and/or improvements to real property directly related to such dwelling units and located on the site of such dwelling units.¹⁵ Accordingly, the Proposed Regulations would make it clear that a land developer or contractor that constructs improvements to real property

directly related to, and located at the site of, a dwelling unit, but does not construct any portion of the dwelling unit, can qualify for the Home Construction Contract Exemption. In addition, the Proposed Regulations provide that, for purposes of determining whether a long-term construction contract is a home construction contract under Regulation section 1.460-3(b)(2), “the term townhouse and rowhouse includes an individual condominium unit.”¹⁶ On April 27, 2009, the American Bar Association Section of Taxation submitted comments in support of the Proposed Regulations (the “Section 460 Comments”). The Section 460 Comments are incorporated herein by reference. The Proposed Regulations have not been finalized. Meanwhile, as a result of the economic downturn, the home construction industry continues to struggle. As noted above, the application of the percentage of completion method of accounting on land and condominium developers would require these developers to pay taxes prior to the receipt of any cash from the sale of homes, which would impose an additional economic burden on the home development industry and would hamper its ability to recover.

¹⁴ 73 Fed. Reg. 45,180 (2008).

¹⁵ Prop. Reg. § 1.460-3(b)(2)(iv)(B).

¹⁶ Prop. Reg. § 1.460-3(b)(2)(iii).

c. Option for Consideration

We offer as an option for your consideration that section 460(e)(6)(A) be amended to incorporate the provisions in the Proposed Regulations to make it clear that the Home Construction Contract Exemption applies to land and condominium developers and contractors. The better interpretation of the current Home Construction Contract Exemption is that it applies to land developers under present law and that the proposed change to section 460(e)(6)(A) should be viewed as a clarification, rather than an expansion, of the scope of the exemption with respect to such contractors.

In addition, many land developers and contractors have accounted for their contracts as home construction contracts based on a reasonable interpretation of the present law. Further, as evidenced by the Proposed Regulations, Treasury and the Service have determined that the Home Construction Contract Exemption should apply to condominium developers and contractors in the same manner as the exemption applies to townhome and rowhouse developers and contractors. The proposed option to amend section 460(e)(6)(A) would further clarify that taxpayers may rely on the Home Construction Contract Exemption, as amended, with respect to taxable years prior to the date the amendment becomes effective.

XVI. Section 465: Revision of At-Risk Rules Relating to Real Estate Activities

a. Present Law

Present law¹⁷ provides an at-risk limitation on losses from business and income-producing activities, including real estate, applicable to individuals and certain closely held corporations. The rule is designed to prevent a taxpayer from deducting losses in excess of the taxpayer’s actual economic investment in an activity. In the case of real estate, the at-risk rules provide an exception for qualified nonrecourse financing which is secured by real property used in the activity, under which the taxpayer is treated as being at-risk with respect to such financing. Qualified nonrecourse financing generally includes financing that is secured by real property used in the activity and that is loaned by a Federal, State or local government or instrumentality thereof or guaranteed by Federal, State or local government, or borrowed by the taxpayer from a qualified person, with respect to the activity of holding real property (other than mineral property). Convertible debt is not treated as qualified nonrecourse financing. The holding of real property includes the holding of personal property and the providing of services which are incident to the use of real property. Qualified persons include any person actively and regularly engaged in the business of lending money. Such persons generally would include, for example, a bank, savings and loan association, credit union, or insurance company regulated under Federal, State or local law, or a pension trust. However, qualified persons do not include (1) any person related to the taxpayer; (2) any person from which the taxpayer acquired the property (or a person related to such person); or (3) any person who receives a fee (e.g., a promoter) with respect to the taxpayer’s investment in the property (or a person related to such person). Thus, for example, seller financing and promoter financing are not qualified nonrecourse financing.

¹⁷ I.R.C. § 465.

b. Reason for Change

Congress believed that the at-risk rules generally should apply in those situations in which tax shelter possibilities - i.e., overvaluation of assets or transfer of tax benefits to a party with no real equity in the property - present themselves.¹⁸

However, where nonrecourse financing constitutes bona fide financing, these tax shelter elements are not present. Similarly, where nonrecourse financing is secured by property in which the debtor has a real equity interest and therefore is likely to make all payments for the property, these tax shelter elements are not present. Our proposed option would identify these situations by revising the existing exclusion for nonrecourse financing in several respects so as to allow taxpayers to utilize legitimate nonrecourse financing that does not raise tax shelter concerns.

¹⁸ H. Rep. No. 99-426, Tax Reform Act of 1985, Report of the Committee on Ways and Means, House of Representatives, on H.R. 3838, December 7, 1985, at 293; and see Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (H.R. 3838, 99th Cong., Pub. L. No. 99514), JCS-10-87, May 4, 1987, at 257.

c. Option for Consideration

Our proposed option contemplates revising the qualified nonrecourse financing provisions of the at-risk rules in various respects. First, the requirement that a qualified person be “actively and regularly engaged in the business” of lending money, and the related exclusion from the definition of a “qualified person” of any person related to the taxpayer, the seller of the property or a promoter, would be removed.¹⁹ Removing this requirement is intended to make it clear that entities, such as investment trusts, single-purpose securitization vehicles and hedge funds, which do not regularly make loans, are not for that reason precluded from being qualified persons. Second, two limited exceptions to the general rule excluding seller financing from the qualified nonrecourse financing exception to the at-risk rules would be added. The first exception would apply to financing extended by a bank or other similar lending institution on the sale of real property that was acquired by the lender through foreclosure (or deed in lieu of foreclosure) of a loan made in the ordinary course of its trade or business. Such seller financing should not present the risk of an inflated purchase price that may otherwise be presented by seller financing. However, the exception would not apply if the lender is related to the taxpayer or receiving fees as a promoter.²⁰ The exception also would not apply in any case in which either the purchase price for the real property is not a fixed amount determined at the time of the sale, or the principal amount of the seller financing or any other amount payable with respect to such financing is dependent, in whole or in part, on the income or profits of the borrower. The second exception would apply to seller financing that is for not more than 85% of the purchase price being paid for the real property, provided that the 15% balance of the purchase price is paid in full by the purchaser in the same taxable year as the sale. Requiring the borrower to have a 15% equity interest in the real property securing the seller financing should assure that the debt is bona fide. As in the case of the other exception for seller financing, this exception would not apply to related party or promoter financing or to seller financing if, in each case, the purchase price is not fixed and determinable at the time of sale. The exception also would not apply if the amount of the seller financing or any amount payable with respect to the financing varies, in whole or in part, based on the income or profits of the borrower.

¹⁹ I.R.C. §49(a)(1)(D)(iv)(I)-(III).

²⁰ I.R.C. §49(a)(1)(D)(iv)(I)-(III).

XVII. Section 469(c)(7): Passive Activity Losses and Credits Limited

a. Present Law

Congress enacted section 469 as part of the Tax Reform Act of 1986.²¹ In general, section 469 prevents a taxpayer from deducting a “passive activity loss.”²² The statute defines passive activity loss as the amount by which the taxpayer's aggregate losses from all passive activities exceed the taxpayer's aggregate income from all passive activities.²³ A passive activity consists of a trade or business in which the taxpayer does not materially participate. Rental activities are per se passive for all taxpayers except that rental real estate activities are not per se passive for qualifying taxpayers (one defined in Regulation section 1.469-9(b)(6) – generally thought of as real estate professionals).²⁴ A qualifying taxpayer must apply the general material participation tests to determine whether a rental real estate activity is passive or active. However, in applying those tests, the qualifying taxpayer may not group a rental real estate activity with any other activity.²⁵ The Treasury Regulations illustrate this rule as follows: “if a qualifying taxpayer develops real property, constructs buildings, and owns an interest in rental real estate, the taxpayer's interest in rental real estate may not be grouped with the taxpayer's development activity or construction activity. Thus, only the participation of the taxpayer with respect to the rental real estate can be used to determine if the taxpayer materially participates in the rental real estate activity under §1.469-5T.”²⁶

²¹ P.L. 99-514, 100 Stat. 2085 §501.

²² I.R.C. §469(a)(1).

²³ I.R.C. §469(d)(1).

²⁴ I.R.C. §§469(c)(2), (7). Congress enacted section 469(c)(7) as part of the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312 (OBRA 1993). Prior to OBRA 1993, all rental activities (including those in which a taxpayer materially participated) were passive to all persons.

²⁵ Treas. Reg. §1.469-9(e)(3)(i).

²⁶ Treas. Reg. §1.469-9(e)(3)(i).

b. Reason for Change

In implementing section 469(c)(7), the Treasury received comments requesting that qualified taxpayers be allowed to group their rental real estate activities with their other activities in determining whether the taxpayers materially participate in the rental real estate activities. ²⁷ The Treasury rejected this request based on its interpretation of the statutory language and the legislative history. The Treasury also rejected the comment that qualifying taxpayers should be allowed to group the activities of development or construction of rental real estate with rental real estate activities. ²⁸ The Treasury's refusal to allow a qualified taxpayer to group all of the taxpayer's real estate activities as a single activity creates additional administrative burdens and can unfairly penalize a qualified taxpayer engaged in multiple real estate activities. For example, assume A and B are equal partners in a management company and a development company. Their business consists of developing rental real estate and then managing it for investors. In addition, they own an interest in the underlying rental real estate they have developed and manage. A is primarily responsible for managing the properties while B is primarily responsible for the development activities. Because of the management services performed for the rental activities, A is considered to materially participate in those rental real estate activities provided he can adequately document the management activities spent on the rental real estate. B, on the other hand, is not able to count her development participation towards the material participation tests with respect to the rental real estate. Thus, B would be unable to use any losses from the rental real estate activity to offset her income from the management and development businesses, while A would be able to use rental activity losses to offset his share of the management and development businesses provided he was able to properly document his activity.

²⁷TD 8645, 12/21/95.

²⁸Id.

c. Option for Consideration

We offer for your consideration the option of amending section 469 to override Regulation section 1.469-9 in order to allow qualified taxpayers to group all of their real estate activities together for purposes of determining whether such taxpayers have materially participated in their rental real estate activities.

XVIII. Sections 469(i) and (j)(5): Passive Loss Rules (Tax Credit Provisions)

a. Present Law

Section 469(i) allows individual taxpayers a \$25,000 deduction equivalent offset to the passive activity credit limitation for rental real estate activities. Although investments in rental activities are generally seen as passive, \$25,000 of losses (or \$9,900 credits, assuming a tax rate of 39.6%) attributable to these activities are allowed to individual taxpayer investors per tax year. This \$25,000 is generally phased out completely for high-income taxpayers with adjusted gross income ("AGI") of \$150,000. Section 469(i)(3)(D) creates an exception from the \$150,000 AGI phase out limit for LIHTC investments. Passive individual investors in LIHTC projects are limited to claiming \$9,900 in tax credits a year.

b. Reason for Change

If the section 469(i) passive activity credit income limitations for sections 42, 45D, 47 and 48 tax credit investments are expanded, this would allow more individual taxpayers to participate in the tax credit equity market making it more efficient. Such a change would allow the credit equity market to tap into much needed larger investor pools.

c. Option for Consideration

Our proposed option would provide that the aggregate amount attributable to any credit determined under sections 42, 45D, 47 and 48, to which section 469(i)(1) applies for any taxable year shall not exceed \$125,000. Our proposed

option also contemplates that section 469(i)(3)(D) be re-enacted so that section 469(i)(3)(A) shall not apply to any portion of the passive activity credit for any taxable year which is attributable to any credit determined under sections 42, 45D, 47 and 48. Finally, our proposed option would revise section 469(i)(6)(B) to include any credit determined under sections 45D and 48 for any taxable year.

XIX. Section 514(c)(9)(E): Revise and Simplify the “Fractions Rule”

a. Present Law

Under section 514, all or a portion of a tax-exempt organization's income with respect to “debt-financed property” generally will be treated as UBTI subject to federal income tax, based on the ratio of the average acquisition indebtedness with respect to the property over the average adjusted basis of the property for the relevant taxable year. Section 514(c)(9), however, provides an exception in the case of real property held by certain tax-exempt organizations (“Qualified Organizations”) if several requirements are met. When a partnership in which the tax-exempt organization is a partner holds the real property, the exception generally will be available only if the partnership's allocations have substantial economic effect under section 704(b) and also satisfy the so-called “fractions rule” contained in section 514(c)(9)(E). Under the fractions rule, the allocation of items to a Qualified Organization cannot result in that partner having an overall share of partnership income for any year greater than such partner's percentage share of overall loss for the year in which the partner's percentage share of overall loss will be the smallest.²⁹ A partnership is required to satisfy the fractions rule on both a prospective and actual basis for each taxable year of the partnership, beginning with the first taxable year in which the partnership holds debt-financed property and has a partner that is a Qualified Organization.³⁰ The applicable regulations contain a number of highly technical and complex rules that, in many ways, dictate the economic terms that real estate partnerships must adopt in order to comply with the fractions rule. An anti-abuse rule contained in the regulations describes the purpose of the fractions rule as follows: The purpose of the fractions rule is to prevent tax avoidance by limiting the permanent or temporary transfer of tax benefits from tax-exempt partners to taxable partners, whether by directing income or gain to tax-exempt partners, by directing losses, deductions, or credits to taxable partners, or by some other similar manner.³¹

²⁹ Treas. Reg. §§1.514(c)-2(b)(1)(i), -2(c)(2).

³⁰ Treas. Reg. §1.514(c)-2(b)(2).

³¹ Treas. Reg. §1.514(c)-2(k)(4).

b. Reason for Change

Although the fractions rule has an anti-avoidance purpose, the rule itself, as implemented under the applicable regulations, adopts an approach that is dramatically overbroad as compared to what is necessary to prevent the stated tax avoidance. In 2010, the ABA Tax Section submitted comments detailing a number of problems presented by the fractions rule in the context of common business arrangements undertaken by investment funds generally.³² Numerous other commentators have also expressed repeated and significant concerns with the fractions rule.³³ The Administration's 2012 Budget contains a proposal that would “revise and simplify the ‘fractions rule.’” The specific proposal is stated as follows: The proposal would replace the fractions rule with a rule that requires each partnership allocation to have substantial economic effect (as required by Present Law) and no allocation to have a principal purpose of tax avoidance. Regulatory authority would be granted to eliminate the “cliff effect” of a technical violation of the rule.³⁴ In describing the reasons for changing from the approach currently taken by the fractions rule, the Administration recognizes that the fractions rule has been heavily criticized for its complexity and unnecessary hindrance of commercially reasonable business transactions.³⁵ The Administration also points to a number of limitations that have been added to the Code since the enactment of section 514(c)(9)(E) to address the ability of taxable investors to use the tax benefits generated by real estate partnerships.³⁶ The Administration specifically cites: “(1) the expansion and refinement of the substantial economic effect rules; (2) the lengthening of the depreciation period for commercial real estate; (3) the enactment of the passive activity loss and at risk rules; and (4) the strengthening of the alternative minimum tax rules.”³⁷ The Administration's proposal concludes that “[t]hese developments alleviate the need for a strict, formulaic fractions rule.”³⁸ The proposal advocated by the Administration largely follows a proposal developed by the New York State Bar Association (Tax Section) in a report published in 1997.³⁹ The theory justifying the proposal as a superior alternative to the fractions rule is well described in that report.

⁴⁰ Our proposed option would both accomplish technical simplification of the Code and eliminate a substantial impediment to investment in U.S. real estate. Given the state of the current real estate market, a proposal that can achieve simplification and encourage economic recovery for the real estate market is highly desirable. **c. Option for Consideration**

³²See Am. Bar. Assoc. (Tax Section), Comments Concerning Partnership Allocations Permitted Under Section 514(c)(9)(E), reprinted at 2010 TAX NOTES TODAY 12-22 (Jan. 20, 2010).

³³See, e.g., ABA Tax Section Asks for Changes in Guidance Regarding Effect of Notice 90-41 on Acquisition Indebtedness, 91 TAX NOTES TODAY 13-11 (Jan. 16, 1991); N.Y. State Bar Says UBTI Rules Carry Too Big a Stick, 91 TAX NOTES TODAY 70-30 (Mar. 29, 1991); California Bar Suggests Elimination of Qualified Allocation Rules, 92 TAX NOTES TODAY 117-46 (June 5, 1992); AICPA Criticizes Proposed Regs as Unnecessarily Complex, 93 TAX NOTES TODAY 87-21 (Apr. 21, 1993); NYSBA Submits Report on Debt-Financed Income Regs, 93 TAX NOTES TODAY 94-21 (Apr. 30, 1993); NYSBA Submits Report on Taxation of Pension Funds, 97 TAX NOTES TODAY 34-39 (Feb. 20, 1997) (hereafter referred to as the "1997 NYSBA Report"); NYSBA Tax Section Submits Report on Debt-Financed Income Subject to UBIT, 2010 Tax Notes Today 156-11 (Aug. 13, 2010).

³⁴See General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals, reprinted at 2011 TAX NOTES TODAY 31-21 (Feb. 15, 2011).

³⁵Id.

³⁶Id.

³⁷Id.

³⁸Id.

³⁹See 1997 NYSBA Report, *supra* note 33.

⁴⁰Id.

Our proposed option would implement the Administration's proposal to "revise and simplify the 'fractions rule.'" This option would replace a highly complex and mechanical rule that creates significant and needless impediments with respect to legitimate, non-abusive commercial arrangements with a prophylactic rule that properly targets the intended abuse.

XX. Sections 856, 857 and 858: Real Estate Investment Trusts

a. Present Law

A real estate investment trust ("REIT") is an entity that otherwise is taxed as a U.S. corporation, but elects to be taxed under a special tax regime applicable to REITs. An electing entity that meets the requirements for REIT status generally is entitled to deduct the portion of its income that is distributed to its shareholders each year as a dividend (like a RIC, but unlike a regular subchapter C corporation). As a result, a REIT's distributed income is not taxed at the entity level; instead, it is taxed only at the shareholder level. To qualify as a REIT, an entity must meet a number of requirements. At least 90% of a REIT's taxable income (other than net capital gain) must be distributed annually. The REIT must derive most of its gross income from real estate-related and passive investments. The REIT's assets must be primarily real estate-related. In addition, a REIT must have transferable ownership interests and at least 100 shareholders. No more than 50% of the REIT's shares/interests may be owned by five or fewer individual shareholders (as determined using specified attribution rules and treating certain entities as "individuals" for this purpose) during the last half of the REIT's taxable year. A REIT generally must use the calendar taxable year, and other requirements also apply. Certain relief provisions may apply to prevent disqualification of the REIT in a specific case. Certain of these REIT requirements are described in more detail below. In order for dividends to be deductible by a REIT, the dividends cannot be "preferential" within the meaning of section 562(c). In general, this requires that the dividends be paid pro rata to all holders within a class of REIT shares, with no preference as to any particular holder of such class, and that distributions paid to holders of a class of shares/interests not be preferential relative to another class of shares/interests, except to the extent the former class is entitled to such preference under the terms of the governing documents.

(i) Income Tests

A REIT generally is restricted to earning certain types of real estate and passive income. Among other requirements, at least 75% of a REIT's gross income in a taxable year (the 75% income test) must consist of certain types of real estate-related income, including rents from real property; income from the sale or exchange of real property (including interests in real property) that is not property described in section 1221(a)(1) (stock in trade, inventory, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business); interests in mortgages secured by real property or interests in real property; and certain amounts received or accrued for entering into contracts to make loans secured by mortgages on real property or interests in real property, or to purchase or lease real property (including interests in real property and interests in mortgages on real property). In addition, at least 95% of a REIT's gross income must be derived from sources that qualify for purposes of the 75% income test, plus certain

types of passive income including interest, dividends, or gain from the sale or other disposition of stock or securities that are not property described in section 1221(a)(1).

(ii) Asset Tests

A REIT generally is restricted to owning certain types of assets. At the close of each quarter of a taxable year, at least 75% of the value of a REIT's total assets (the 75% asset test) must be represented by real estate assets (which include real estate mortgage loans), cash and cash items (including receivables) and government securities. Furthermore, not more than 25% of the value of its assets may be represented by securities (other than those described in the preceding sentence), and not more than 25% of the value of its assets may be represented by securities of one or more taxable REIT subsidiaries ("TRSs"). Finally (except with respect to securities includible under the 75% asset test or securities of TRSs), not more than five percent of the value of its total assets may be represented by securities of any one issuer; the REIT may not hold securities possessing more than ten percent of the total voting power of any one issuer; and the REIT may not hold securities having a value of more than ten percent of the total value of the outstanding securities of any one issuer. Certain exceptions to the ten percent value test may apply to debt securities that do not qualify as real estate mortgages.

(iii) Prohibited Transactions Tax

REITs are subject to a confiscatory prohibited transactions tax equal to 100% of the net income derived from prohibited transactions. For this purpose, a prohibited transaction is a sale or other disposition of property described in section 1221(a)(1) that is not foreclosure property. The prohibited transactions tax does not apply to a sale if the REIT satisfies certain safe harbor requirements in section 857(b)(6)(C) (applicable to rental real estate assets) or section 857(b)(6)(D) (applicable to real estate assets held in connection with the trade or business of producing timber), including an asset holding period of at least two years.

b. Reason for Change

Our proposed options include modifications that will enable REITs to operate more efficiently, but also in a manner consistent with the underlying Congressional purposes in enacting a modified single-tax regime for REITs. In addition, Congress has in recent years enacted certain temporary relief provisions for timber REITs which have since expired. Those temporary provisions, which treated certain types of gross income as qualifying gross income, eliminated uncertainty and enabled timber REITs to operate more efficiently and in a manner consistent with the underlying purposes of the REIT rules. Our proposed options would make these provisions permanent and would provide similar relief for other types of REITs deriving such gross income. The prohibition against paying preferential dividends under section 562(c) has created a major trap for REITs and carries with it an extremely harsh penalty – potential loss of REIT status – if the disallowance of a deduction causes the REIT to fail the 90% distribution requirement. In practice, preferential dividend issues can arise in many circumstances where there is no tax planning motive or tax abuse present, including minor administrative or clerical errors in failing to pay out distributions in strict accordance with the REIT's governing documents. The policy considerations underlying the preferential dividend rule may have made some sense in the context of the personal holding company deduction for dividends paid (the context in which this provision originally came into law), but appear to have little, if any, compelling policy justification for REITs.

c. Options for Consideration

Our proposed options include the provisions described below that we believe would eliminate certain areas of uncertainty with respect to the income tests, the asset tests, the prohibited transactions tax and the treatment of certain items to shareholders of REITs, and to relieve the burden of draconian penalties, including in certain cases the potential loss of REIT status, for violation of certain REIT requirements.

(i) Income Tests

As discussed above, a REIT generally is restricted to earning certain types of real estate and passive income. In that regard, section 856(c)(2)(I) temporarily treated as qualifying income under the 95% gross income test "mineral royalty income" earned by a "timber REIT" from real property held, or once held, in connection with the trade or business of producing timber. A REIT is a timber REIT if more than 50% in value of its total assets consists of real property held in connection with the trade or business of producing timber. Under our proposed option, the mineral royalty income provision would be reinstated and made permanent and extended to all REITs, regardless of whether they qualify as timber REITs. Section 856(c)(5)(H) likewise temporarily treated certain gain from the disposition of timber under both sections 631(a) and (b) as qualifying gain from the sale of real property for purposes of the 75% and 95% gross

income tests. This provision has also expired, but under our proposed option would be reinstated and made permanent. Section 856(c)(5)(G) currently provides that income from certain hedging transactions is excluded from gross income for purposes of the income tests. Specifically, section 856(c)(5)(G)(i) excludes from gross income any income or gain from a hedging transaction (as defined under sections 1221(b)(2)(A)(ii) and (iii)) which is clearly identified pursuant to section 1221(a)(7), but only to the extent that the transaction hedges any indebtedness incurred, or to be incurred, by the REIT to acquire or carry real estate assets. Because the hedge must relate to debt incurred to acquire or carry real estate assets, a hedge transaction that is entered into to economically offset (in whole or in part) a preexisting hedge transaction that survives the repayment of the debt which the preexisting transaction was intended to hedge does not appear to qualify under section 856(c)(5)(G)(i). For example, if a fixed rate swap is entered into to hedge a variable rate loan, and that loan is later refinanced prior to maturity with a fixed rate loan, the REIT may not be able to terminate the preexisting hedge without incurring a substantial termination fee. Thus, the REIT may, for business reasons, prefer not to terminate that hedge transaction but instead enter into a new offsetting hedge transaction. Although the new hedge can still qualify as a hedging transaction under the regulations under section 1221 (provided it is properly identified as such), the new hedge does not appear to qualify for the REIT gross income exclusion. Accordingly, we propose for your consideration that section 856(c)(5)(G)(i) be modified to apply (i) to any hedge entered into primarily to offset all or any part of the risk management effected by a preexisting hedge which qualified under such provision, and (ii) to continue to apply to the preexisting hedge.

(ii) Asset Tests

A REIT generally is restricted to owning certain types of assets. As discussed in more detail above, at the close of each quarter of a taxable year, at least 75% of a REIT's total assets must be represented by real estate assets, cash and cash items (including receivables) and government securities. Although stock of a REIT is considered a "real estate asset" for this purpose, a debt security of a REIT is not considered a "real estate asset" for this purpose except to the extent it is secured by a mortgage on real property. Thus, a REIT that invests in such debt is subject to the limitation that such debt issued by any single REIT cannot exceed five percent of the investing REIT's total gross assets.

A substantial amount of debt issued by publicly held REITs (or their subsidiary UPREIT partnerships) is not secured by interests in real property but instead is a general unsecured obligation of the REIT or its UPREIT partnership. An investment in unsecured debt of a REIT can be viewed as substantially equivalent to an investment in the underlying assets of the obligor REIT, which of necessity must consist primarily of real estate assets. Accordingly, under our proposed option debt securities issued by a publicly held REIT or its subsidiary UPREIT partnership would be treated as a "real estate asset" as to the holder, subject to the limitation that the total unsecured debt securities of one or more issuing REITs held by a particular investing REIT do not represent more than 25% of the investing REIT's gross assets. Our proposed option further contemplates that a qualifying UPREIT partnership would be defined as any partnership through which the publicly held REIT holds substantially all of its assets. The income test treats rental income attributable to personal property leased in connection with real property (e.g., kitchen appliances in an apartment) as qualifying rental income so long as the rent attributable to such personal property for the taxable year does not exceed 15% of the total rent received under the property lease for the taxable year. We propose as an option for your consideration that a similar rule be adopted for purposes of the asset test. Under this rule, personal property leased in connection with real property will itself be treated as real property for purposes of the asset test so long as the value of the personal property does not exceed 15% of the total fair market value of the property subject to the lease. Similarly, our proposed option also contemplates that personal property associated with real property securing a mortgage loan should be treated as real property so long as the fair market value of such personal property does not exceed 15% of the total value of all the property securing the mortgage loan on the date such loan is originated or acquired by the REIT.

(iii) Increase one percent De Minimis Basket to five percent

"Rents from real property" is a key category of qualifying gross income in both the 95% and 75% gross income tests. The term includes rents from interests in real property and charges for services (whether or not separately stated) that are customarily furnished or rendered in connection with the rental of real property, but excludes "impermissible tenant service income" ("ITSI") as defined in section 856(d)(7). Under the general rule, ITSI includes any amount received by the REIT for services furnished or rendered by the REIT to the tenant or for managing or operating the property. Section 856(d)(7)(C)(ii) substantially narrows the scope of the general rule by excluding from ITSI any amounts which would be excluded from UBTI under section 512(b)(3) if received by a tax-exempt organization. In general, rents are excluded from UBTI unless services are provided to the tenant that are not usually and customarily provided in connection with the rental of space for occupancy only. Section 856(d)(7)(B), however, effectively overrides this critical ITSI exclusion if the total value of nonqualifying services provided to tenants exceeds one percent of the total amounts derived from the property. In determining whether the one percent threshold is exceeded, the nonqualifying services

cannot be valued at less than 150% of the direct costs of furnishing the service. Even if the one percent de minimis exception applies, the amount that goes into the one percent basket is still treated as nonqualifying income for purposes of the REIT gross income tests. A REIT that is faced with a one percent de minimis basket problem can seek to provide problematic noncustomary services through a TRS or through a qualifying independent contractor, but the arrangement with the independent contractor must meet certain requirements. Because noncustomary services must be valued at no less than 150% of direct cost, it is possible for relatively minor services whose tax classification may be “bad,” or at the very best uncertain, to exceed one percent of the annual rent roll of a particular property. In addition, the Service has ruled that if the value of noncustomary services provided by a REIT exceeds the one percent basket, every dollar of rent from all tenants located at that “property” becomes nonqualifying gross income – not just the value of the “bad” services. This means that a relatively innocuous amount of noncustomary services can taint all of the rents of a particular office building, shopping mall or other property, which can easily cause a REIT to violate the 95% gross income test and, thus, put its REIT qualification in jeopardy. Moreover, determining whether a particular service or amenity is “good” or “bad” is inherently fact-sensitive and uncertain. As a result, a REIT may be forced to either discontinue the problematic services or restructure the service arrangement in some manner, such as providing it through a TRS or an independent contractor. REITs and their tax advisors devote considerable time and expense dealing with such issues, even though the problematic services may be wholly ancillary to the REIT’s fundamental business of owning and leasing real property. Treating an entire property’s gross revenue as bad income when the one percent de minimis test is violated is a sanction that, in many cases, is grossly disproportionate to any real or perceived abuse of the REIT tax regime. Accordingly, we offer for your consideration the option of increasing the one percent de minimis exception to five percent. This expansion of the one percent basket will give REITs more flexibility to deal with tenant services or amenities whose tax status may be unclear without forcing those services to be restructured or discontinued. Since all amounts that fall into the revised five percent de minimis basket would still be treated as nonqualifying gross income for purposes of the 95% gross income test, the latter test would continue to function as a major constraint on the REIT’s ability to generate revenue from nonqualifying services and activities.

(iv) Prohibited Transactions Tax

As described above, REITs are subject to a prohibited transactions tax of 100% of the net income derived from prohibited transactions, which generally involve “dealer” sales of property. The prohibited transactions tax does not apply if the REIT satisfies certain safe harbor requirements or if the REIT is considered not to be a dealer as to a particular transaction under all the surrounding facts and circumstances. One of the safe harbors (the “seven-sale safe harbor”) applies only if the REIT does not make more than seven sales of property during the taxable year (subject to certain exclusions). In practice, this sales volume limitation has proved to be far too restrictive to be helpful to REITs with large property portfolios. A second safe harbor (the “ten percent safe harbor”) applies if, among other requirements, the aggregate adjusted bases or fair market values of property sold during the taxable year (excluding certain foreclosures and condemnations) do not exceed ten percent of the aggregate adjusted bases or market values, respectively, of all the REIT’s property (as so determined) as of the beginning of the taxable year. While this safe harbor might be helpful for many REITs with large portfolios, the ten percent safe harbor contains an additional restriction that greatly limits its utility. In particular, it requires that substantially all of the marketing and development expenditures with respect to the property sold must be made through an independent contractor from whom the REIT itself did not derive or receive any income. This provision is intended to prevent the REIT from conducting development and marketing activities internally and, thus, helping to ensure that the REIT’s activities with respect to the property did not cross the dealer line. For many REITs, the ten percent safe harbor is, for all practical purposes, the only safe harbor upon which they can reasonably hope to rely to protect against a potential dealer issue being asserted by the IRS. Yet, even this rule, which roughly correlates to a ten percent yearly permitted turnover (provided the REIT has held the properties disposed of for at least two years and, in the case of real properties, has held them for lease for at least two years), is too restrictive in practice. For example, a REIT may determine to exit a particular market entirely in which it has a large portfolio of properties which it has held for lease for many years. This sales volume might well exceed ten percent of beginning-of-year total assets. The ten percent safe harbor is also dependent on accurate property valuations. Finally, the independent contractor requirement is problematic for those REITs that develop and market their properties with their own personnel (something which REITs have been allowed to do since 1986). Consequently, many REITs have little choice but to apply the facts and circumstances dealer test to each property sale, thus running the risk of a confiscatory tax if they incorrectly apply the facts and circumstances dealer test to a particular transaction. REITs expend considerable time and resources analyzing dealer status in circumstances that are often far removed from those activities that are well understood to be traditional dealer activities, such as lot subdivision and sales, home sales, condominium sales, etc., yet which cannot be automatically ruled out as dealer activities because of the absence of any “bright line” standards.

Accordingly, we offer as an option for your consideration that the ten percent safe harbor be modified so that a REIT (i) may sell up to 20% of the aggregate adjusted bases or market values of all properties held as of the beginning of the

taxable year, and (ii) can market property through a TRS as well as through an independent contractor. A TRS ordinarily does not qualify as an independent contractor because of the REIT's ownership of the TRS's shares. However, because a TRS is a taxpaying corporation, it will be subject to corporate tax on income derived from its marketing activities, and the REIT is potentially subject to excise taxes if the TRS is not fairly compensated for its marketing activities. Since the *raison d'être* for a TRS is to engage in activities that a REIT could not conduct directly, with the *quid pro quo* being the payment of corporate level income tax on income from such activities, it is consistent with the policy of the REIT rules to permit marketing activities to be done through a TRS without compromising the purposes of the ten percent safe harbor. Finally, given that REITs have for many years been permitted to develop and improve their real properties, our proposed option contemplates that the safe harbor requirement that all development expenditures be made through an independent contractor would be removed, so that such expenditures can be made within the safe harbor either through a TRS or directly by the REIT itself. The REIT would continue to be subject to the other safe harbor requirements, including the two-year holding period requirement and the requirement that any land or improvements be held for lease for at least two years, which are material constraints on a REIT's ability to engage in dealer activities.

(v) Preferential Dividends

As discussed above, a REIT generally is entitled to claim a deduction for dividends paid to its shareholders. A REIT, however, may not deduct a dividend that is considered to be "preferential." REITs, both public and private, regularly encounter preferential dividend issues in circumstances where there is no tax avoidance motive or abuse of the REIT provisions. Often this results in tax advisors being unable to render an unqualified opinion on REIT tax status without obtaining confirmation from the IRS (by way of a closing agreement or otherwise, which may require payment of a penalty or fine) that the deductibility of the REIT's dividends was not compromised. Preferential dividend issues arise not infrequently and, once identified – typically in the context of a capital markets transaction, such as an M&A transaction, equity offering or financing – they tend to delay the transaction and consume inordinate time and expense until resolved. In that regard, a similar rule historically has applied to a RIC. The Regulated Investment Company Modernization Act of 2010⁴¹ repealed the preferential dividend rule with respect to a publicly offered RIC as defined in section 67(c)(2)(B). The Administration's 2012 Budget proposed to extend this repeal to public REITs and to provide Treasury with the authority to cure inadvertent failures of the preferential dividend rule by other REITs. Under our proposed option, the interests of tax simplification would be greatly served by repealing the preferential dividend rule outright for all RICs and REITs, whether or not they are publicly traded. At a minimum, however, our proposed option contemplates that the Administration's 2012 Budget proposal

⁴¹ Pub. L. No. 111-325, 124 Stat. 3537.

(including Treasury's authority to cure inadvertent preferential dividend failures) for REITs would be implemented except that the repeal of the preferential dividend rule would apply to all REITs required to register their securities under the Securities Exchange Act of 1934.

(vi) Withholding Tax on "Interest Related" Dividends

In 2004, Congress enacted section 871(k), which essentially exempted from the U.S. 30% withholding tax "interest-related dividends" paid by RICs (mutual funds) to non-U.S. investors with respect to taxable years of RICs beginning after December 31, 2004, and ending on or before January 1, 2008 (a three-year period). An interest-related dividend is, very generally, a dividend designated by the RIC as such, but not in excess of the qualified net interest income of the RIC for such taxable year. In 2008, Congress extended this provision for two years, through 2009. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010,⁴² extended this provision an additional two years, through 2011 and the American Taxpayer Relief Act of 2012 further extended this provision through 2013.⁴³ The purpose of this provision is to eliminate a tax disincentive to foreign investment in mutual funds and to facilitate access to foreign capital. Many REITs, and particularly public mortgage REITs that invest primarily in debt securities, invest in real estate mortgages and other debt securities. Interest on such securities, if received directly by a non-U.S. investor, is often exempt from the 30% U.S. withholding tax under a Code-based exception, such as the "portfolio interest" or "bank deposit" exemption. While a REIT may designate a portion of its dividends as capital gain dividends to the extent of its net capital gain for the taxable year, it is not permitted to pass the tax character of interest income out to its shareholders, which has the effect for non-U.S. investors in REITs of converting what would be nontaxable interest income to taxable dividend income. The policy considerations behind section 871(k), which are to encourage and facilitate access to non-U.S. capital, also apply to REITs. Accordingly, under our proposed option this RIC relief provision would be extended to interest-related dividends paid by REITs and this provision would be made permanent for both RICs and REITs.

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Pub. L. No. 111-312, 124 Stat. 2504.

⁴³ Pub. L. No. 112-240, 126 Stat. 2313.

(vii) Modification of E&P Rules to Prevent Double Taxation of REIT Shareholders

A REIT is entitled to deduct dividends paid to its shareholders in determining its REIT taxable income. A distribution by a REIT generally is treated as a dividend, and therefore deductible, to the extent paid out of the REIT's current or accumulated earnings and profits ("E&P"). If the REIT distributes amounts in excess of E&P, the excess is treated as a nondeductible return of capital rather than as a taxable dividend. Section 857(d) provides that the E&P of a REIT for any taxable year shall not be reduced by any amount that is not allowable in computing its taxable income for such year. Thus, for example, if the REIT incurs a \$100 cash outlay which is nondeductible for purposes of determining REIT taxable income (thus effectively increasing REIT taxable income), such amount may nevertheless reduce E&P (but for the section 857(d) special rule) and thus reduce the portion of the REIT's distributions treated as deductible dividends. This could result in undistributed taxable income at the REIT level and hence a REIT level tax, even though the REIT in fact made cash distributions in excess of taxable income. The purpose of the section 857(d) rule is to ensure that the REIT has sufficient E&P to support the payment of deductible "dividends" that will zero out its taxable income. However, section 857(d) literally appears to apply at the shareholder level as well — that is, to determine the portion of REIT distributions that is treated as a taxable "dividend" rather than a return of capital. This can result in the shareholder paying tax on distributions that are economically a return of capital and, depending on the facts and the nature of the underlying disallowed amount, can result in the shareholder reporting excessive dividend income over time as compared to the tax treatment of a shareholder in a non-REIT corporation. Consequently, we propose as an option for your consideration that section 857(d) be modified to apply only for purposes of calculating the REIT's dividends paid deduction and not for purposes of determining the taxability of distributions at the shareholder level.

XXI. Section 1031: Exchange of Property Held for Productive Use or Investment

a. "Held For" Requirement

(i) Present Law

Section 1031(a) provides that a taxpayer recognizes no gain or loss on the exchange of property "held for productive use in a trade or business or for investment" solely for property of like kind "which is to be held either for productive use in a trade or business or for investment." Section 1031(b) provides that gain is recognized in an otherwise tax-free like-kind exchange to the extent of the amount of cash and the fair market value of other property that is not of like kind that the exchanging taxpayer receives in the exchange. ⁴⁴ The position of the Service is that an exchange that is otherwise tax-free under section 1031 violates the "held for" requirement and, thus, is rendered fully taxable if the exchange transaction closely precedes or follows another tax-free transfer. ⁴⁵ However, the courts generally have held in favor of the taxpayer on this issue. ⁴⁶

⁴⁴ Special rules are provided under I.R.C. §1031 for exchanges of livestock of different sexes, related party transactions, property located outside the U.S., and certain other situations.

⁴⁵ See, e.g., Rev. Rul. 75-292, 1975-2 C.B. 333 (exchange immediately followed pursuant to a prearranged plan by I.R.C. §351 transfer violated "held for" requirement under I.R.C. §1031(a)); see also Rev. Rul. 77-337, 177-2 C.B. 305 (receipt of property in a tax-free liquidation under I.R.C. §333 of prior law immediately followed pursuant to a prearranged plan by an exchange violated "held for" requirement under I.R.C. §1031(a)).

⁴⁶ See, e.g., *Magneson v. Commissioner*, 753 F.2d 1490 (9th Cir. 1985); *Bolker v. Commissioner*, 760 F.2d 1039 (9th Cir. 1985); *Maloney v. Commissioner*, 93 T.C. 89 (1989).

(ii) Reason for Change

Based on a number of court decisions, the held for requirement under section 1031(a) can and should be applied and satisfied by imputing the held for purpose to or from the exchanging taxpayer following or preceding an otherwise tax-free exchange. Under this approach, an exchange that is otherwise tax-free under section 1031 does not violate the "held for" requirement if the exchange transaction closely precedes or closely follows another tax-free transfer. Moreover, it appears that, following its court losses, the Service is no longer litigating this issue. Nevertheless, the Service has not revoked or modified Rev. Rul. 75-292 or Rev. Rul. 77-337.

(iii) Option for Consideration

We propose as an option for your consideration that Congress amend section 1031 to provide that an exchange that is

otherwise tax-free under section 1031 does not violate the “held for” requirement if the exchange transaction closely precedes or follows another tax-free transfer. It would follow that the Service would then revoke Rev. Rul. 75-292⁴⁷ and Rev. Rul. 77-337.⁴⁸

⁴⁷1975-2 C.B. 333.

⁴⁸1977-2 C.B. 305.

b. Inequitable Interaction with Sections 108 and 1017

(i) Present Law

Under section 1017(a), if a taxpayer excludes COD Income from gross income under section 108, other than under section 108(c), an amount equal to such excluded income (subject to certain limitations) is applied to reduce basis of the property held by the taxpayer. Under section 1017(d)(1)(A), if the property which is subject to the basis reduction is neither section 1245 property, nor section 1250 property (for example raw land), such property is treated as section 1245 property for recapture purposes. Under sections 1245(a) and (b)(4), the section 1031 non-recognition rule is essentially overridden to the extent section 1245 property (including property deemed to be section 1245 property under section 1017(d)(1)(A)) is not exchanged for other section 1245 property. If a taxpayer utilized the provisions of sections 108 and 1017 to exclude COD Income with respect to its raw land, such taxpayer would not be able to utilize section 1031 to defer recognition to the extent it attempted to exchange such property with other raw land, as such raw land replacement property could not be section 1245 property.

(ii) Reason for Change

The purpose of treating property that is neither section 1245 property nor section 1250 property as section 1245 property for recapture purposes under section 1017 is to ensure that at some point the excluded COD Income is recaptured. However, in a situation where raw land is exchanged for other raw land, the section 1245 rule defeats the main purpose of section 1031 which is to permit deferral for like-kind property exchanges and the plain meaning of section 1245 which permits exchanges of similar type property.

(iii) Option for Consideration

We propose as an option for your consideration that section 1245(b)(4) be modified to provide an exception for recapture if the property is deemed to be section 1245 property under section 1017(d)(1)(A) and the exchange otherwise qualifies for gain deferral under section 1031, but the potential section 1245 recapture inherent in the relinquished property disposed of in the exchange will be carried over to the replacement property received in the exchange.

XXII. Section 1033: Involuntary Conversions - Inequitable Interaction with Sections 108 and 1017

a. Present Law

Under section 1017(a), if a taxpayer excludes COD Income from gross income under section 108, other than under section 108(c), an amount equal to such excluded income (subject to certain limitations) is applied to reduce basis of the property held by the taxpayer. Under section 1017(d)(1)(A), if the property which is subject to the basis reduction is neither section 1245 property, nor section 1250 property (for example raw land), such property is treated as section 1245 property for recapture purposes. Under sections 1245(a) and (b)(4), the section 1033 non-recognition rule is essentially overridden to the extent section 1245 property (including property deemed to be section 1245 property under section 1017(d)(1)(A)) is not replaced with other section 1245 property.

b. Reason for Change

If a taxpayer utilized the provisions of sections 108 and 1017 to exclude COD Income with respect to its raw land, such taxpayer would not be able to utilize section 1033 to defer recognition to the extent it attempted to replace the converted property with other raw land, as such raw land replacement property could not be section 1245 property. The purpose of treating the property that is neither section 1245 property nor section 1250 property as section 1245 property for recapture purposes under section 1017 is to ensure that at some point the excluded COD Income is recaptured. However, in a situation where raw land is involuntarily converted into other raw land, the section 1245 rule defeats the main purpose of section 1033 and the plain meaning of section 1245 which permits replacement with similar property.

c. Option for Consideration

We propose as an option for your consideration that section 1245(b)(4) be modified to provide an exception for recapture if the property is deemed to be section 1245 property under section 1017(d)(1)(A) and the involuntary conversion otherwise qualifies for gain deferral under section 1033, but the potential section 1245 recapture inherent in the condemned or involuntarily converted property will be carried over to the replacement property acquired by the taxpayer as part of the section 1033 transaction.

General Information

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