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Big Thinking. Personal Focus.

Current Trends in Real Estate Transactions:

Strategic Transaction Planning to Maximize Your Investment

Presented by:

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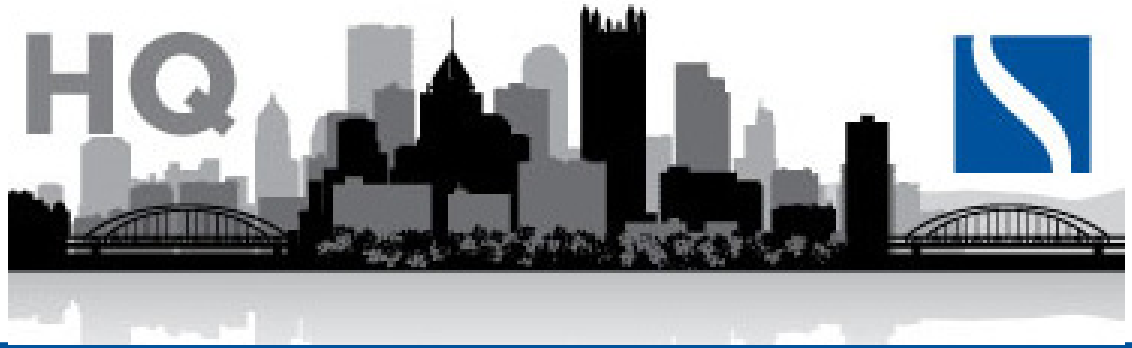

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About the Real Estate Industry Group

- Extensive portfolio of real estate, real estate-related clients, including developers, brokerage and commercial real estate entities
- Integrated service delivery model, leveraging resources from multiple disciplines – e.g. audit, tax, advisory, estate and trust, technology and state and local tax matters
- Experience serving large, complex, family-owned and multi-generational businesses involved in the real estate industry
- Broad range of professional experience and backgrounds
- Active member in local real estate industry professional associations

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Real Property Tax Planning

1) Investment by Non-US Persons
2) Leveraged Partnerships / Disguised Sales
3) Like-Kind Exchange Planning for Partnerships

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November 12, 2015

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GENERAL CONCEPTS

Taxation of Non-U.S. Persons

- U.S. source fixed, determinable, annual or periodical income (i.e., dividends, interest, rents) ("FDAP Income"): typically income not effectively connected with a trade or business in the United States.
- 30% U.S. withholding tax on gross basis, but subject to reduction under applicable tax treaties.
- Generally no U.S. tax return filing obligation for FDAP Income.

Taxation of Non-U.S. Persons

- Foreign Account Tax Compliance Act ("FATCA"):
  - New reporting and withholding regime.
  - 30% withholding on any "withholdable payment" (i.e., U.S. source FDAP Income, and gross proceeds from the sale or other disposition of a security that can give rise to the payment of FDAP Income) made to "foreign financial institutions" and "non-financial foreign entities" unless they comply with certain due diligence and reporting requirements.
  - Withholdable payments do not include income that is effectively connected with the conduct of a U.S. trade or business.

Taxation of Non-U.S. Persons

- U.S. source income effectively connected with a trade or business in the United States - subject to U.S. income tax at regular rates.
- Corporations taxed at a maximum rate of 35% under current law on ordinary income and capital gains.
- Individuals taxed at a maximum rate of 39.6% under current law on ordinary income, and 20% on long-term capital gains.

Taxation of Non-U.S. Persons

- Additional 30% “branch profits tax” imposed on non-U.S. corporations; the 30% may be reduced by applicable tax treaty or by U.S. domestic law.
- Tax return filing obligations.

Taxation of Non-U.S. Persons

- Disposition of “U.S. real property interest” subject to U.S. tax payment and tax return filing requirements.
- A U.S. real property interest includes (a) U.S. real estate and (b) a U.S. corporation if the fair market value of such corporation’s U.S. real property interests equals or exceeds 50% of the fair market value of the corporation’s (i) U.S. real property interests, (ii) interests in real property located outside the United States and (iii) any assets used in a trade or business.

Taxation of Non-U.S. Persons

- "Foreign governments" are exempt from U.S. tax on income from the following sources under Section 892 of the United States Internal Revenue Code of 1986, as amended (the "Code"):
  - Stocks, bonds or other domestic securities.
  - Financial instruments held in the execution of governmental financial or monetary policy.
  - Interest on bank deposits.

Taxation of Non-U.S. Persons

- A foreign government for Section 892 purposes means the (i) integral parts or (ii) controlled entities of a foreign sovereign.
- An “integral part” of a foreign sovereign is any person, body of persons, organization, agency, bureau, fund, instrumentality, or other body, however designated, that constitutes a governing authority of a foreign country.
  - The net earnings of the governing authority must be credited to its own account or to other accounts of the foreign sovereign, with no portion inuring to the benefit of any private person.

Taxation of Non-U.S. Persons

- A controlled entity is one that is separated in form from a foreign sovereign and that meets the following requirements:
  - It is wholly owned and controlled by a foreign sovereign directly or indirectly through one or more controlled entities.
  - It is organized under the laws of the foreign sovereign by which owned.
  - Its net earnings are credited to its own account or to other accounts of the foreign sovereign, with no portion of its income inuring to the benefit of any private person.
  - Its assets vest in the foreign sovereign upon dissolution.

Taxation of Non-U.S. Persons

- Section 892 exemption is not available for income derived from the conduct of any commercial activities (i.e., activities conducted with a view towards the current or future production of income or gain).
  - Pure investment activities such as investments in stocks or financial instruments, net leases on real property, or loans, are not treated as commercial activities.
- Section 892 exemption is also not available for income received by or from a controlled commercial entity of a foreign government.

Taxation of Non-U.S. Persons

- A controlled commercial entity is an entity engaged in commercial activities and in which a foreign government (i) holds (directly or indirectly) any interest in such entity which (by value or voting power) is 50% or more of the total of such interests in such entity, or (ii) holds (directly or indirectly) a sufficient interest (by value or voting power) or any other interest in such entity which provides the foreign government with effective practical control of such entity.

Interest Stripping

- Non-U.S. investors can capitalize their interest in the U.S. corporation with debt.
- The U.S. corporation is subject to U.S. tax, but its tax liability may be reduced by its interest deductions on the loan from the non-U.S. investors plus its depreciation deductions from the real property.
- Interest Stripping rules disallow interest deductions to extent in excess of 50% of taxable income in some situations.
- Safe harbors – but often not applicable to real estate.
- Applies to interest paid to related parties only.
- Disallowed interest can be carried forward.

Portfolio Interest

- Interest paid by the U.S. corporation to the non-U.S. investors is treated as “portfolio interest” and is exempt from U.S. withholding tax as long as the non-U.S. investors do not own 10% or more of the voting stock of the U.S. corporation and provide certificates of non-U.S. status (i.e., on an Internal Revenue Service Form W-8) to the U.S. corporation, and the debt instrument satisfies the requirements to be a “registered obligation” under the portfolio interest rules.
  - If the portfolio interest exemption above does not apply, interest paid by the U.S. corporation to the non-U.S. investors is subject to a 30% U.S. withholding tax, which may be reduced by applicable tax treaty
  - No income tax filing obligation with respect to interest received from the U.S. corporation.

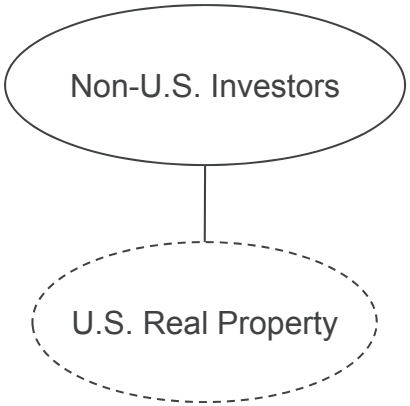
AHYDOs -- U.S. Tax Considerations:

- The deductibility of interest payments made by the U.S. corporation may be limited if the debt owed by the U.S. corporation to the non-U.S. investors is treated as an "applicable high-yield discount obligation."
  - An "applicable high-yield discount obligation" is a debt instrument meeting all of the following requirements: (i) the maturity date is more than 5 years from the issue date, (ii) the yield to maturity equals or exceeds 5 percentage points plus the applicable federal rate and (iii) the instrument has significant original issue discount (i.e., the unpaid original issue discount exceeds the product of the issue price and the yield to maturity).

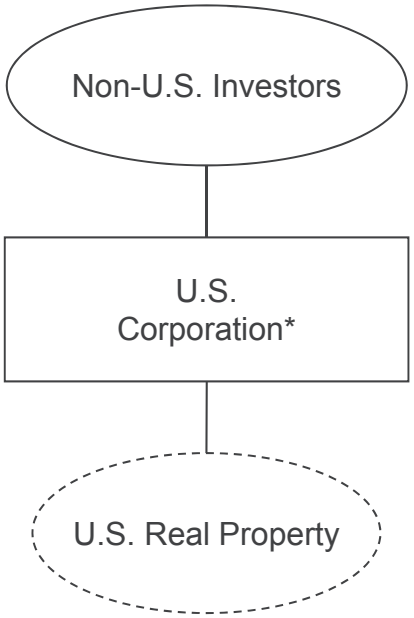
BASIC INVESTMENT STRUCTURES FOR NON-U.S. INVESTORS

- Direct Investment.
- Investment through U.S. corporation.
- Investment through U.S. real estate investment trust.
- Investment through non-U.S. corporation.
- Investment through two-tier corporate structure.
- Investment through partnership.

Direct Investment

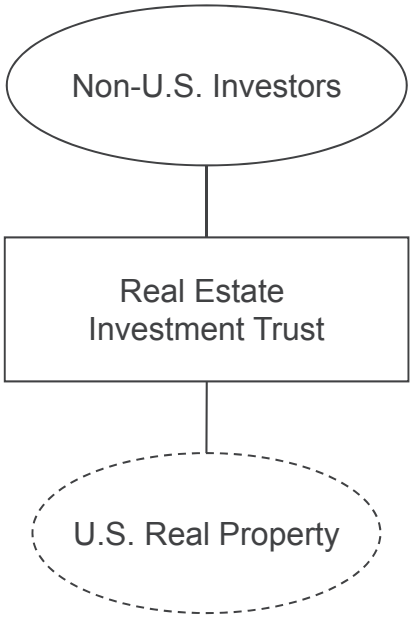


Investment Through U.S. Corporation

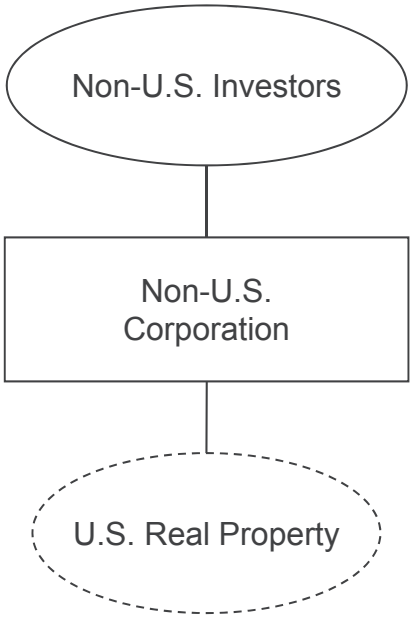


*The U.S. corporation may also hold the real property through one or more wholly-owned U.S. limited liability companies. A wholly-owned U.S. limited liability company is disregarded for U.S. tax purposes and may be used to shield the U.S. corporation from liabilities assuming the U.S. corporation has other assets.

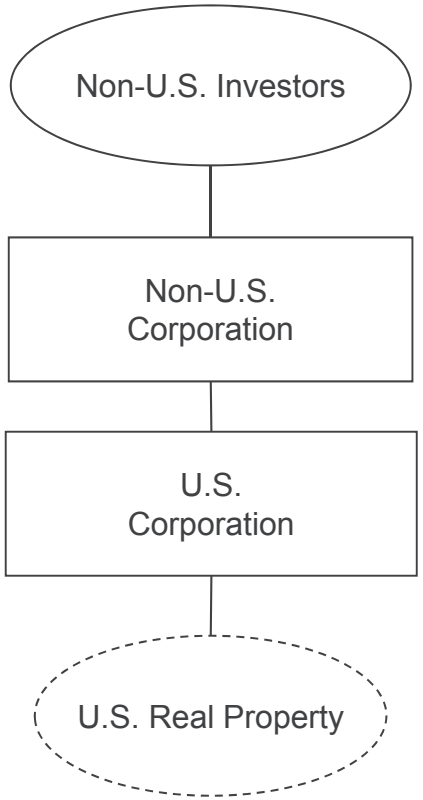
Investment Through Real Estate Investment Trust



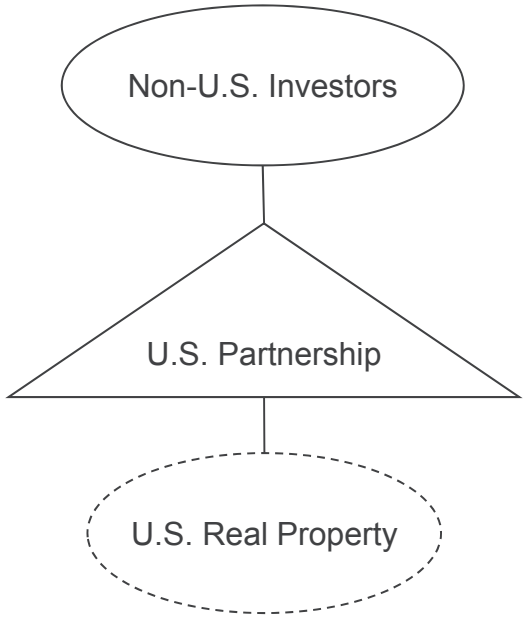
Investment Through Non-U.S. Corporation



Investment Through 2-Tier Corporate Structure



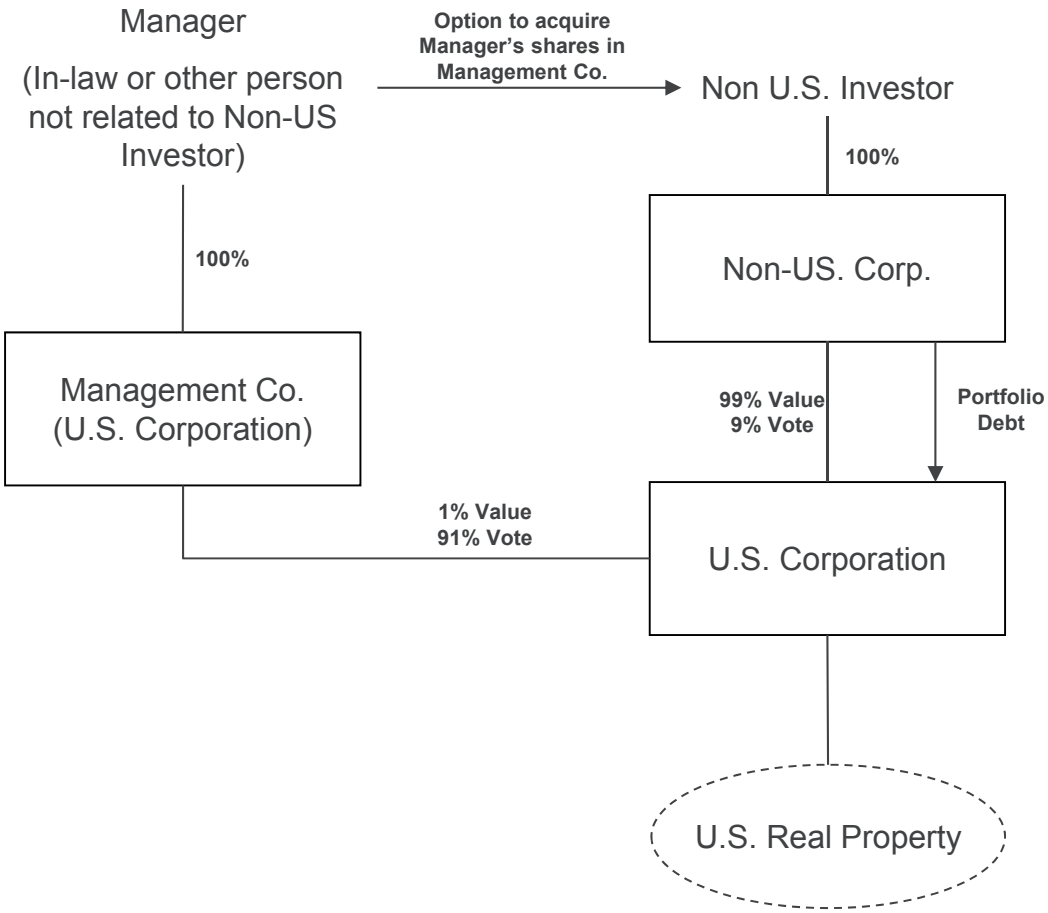
Investment Through Partnership



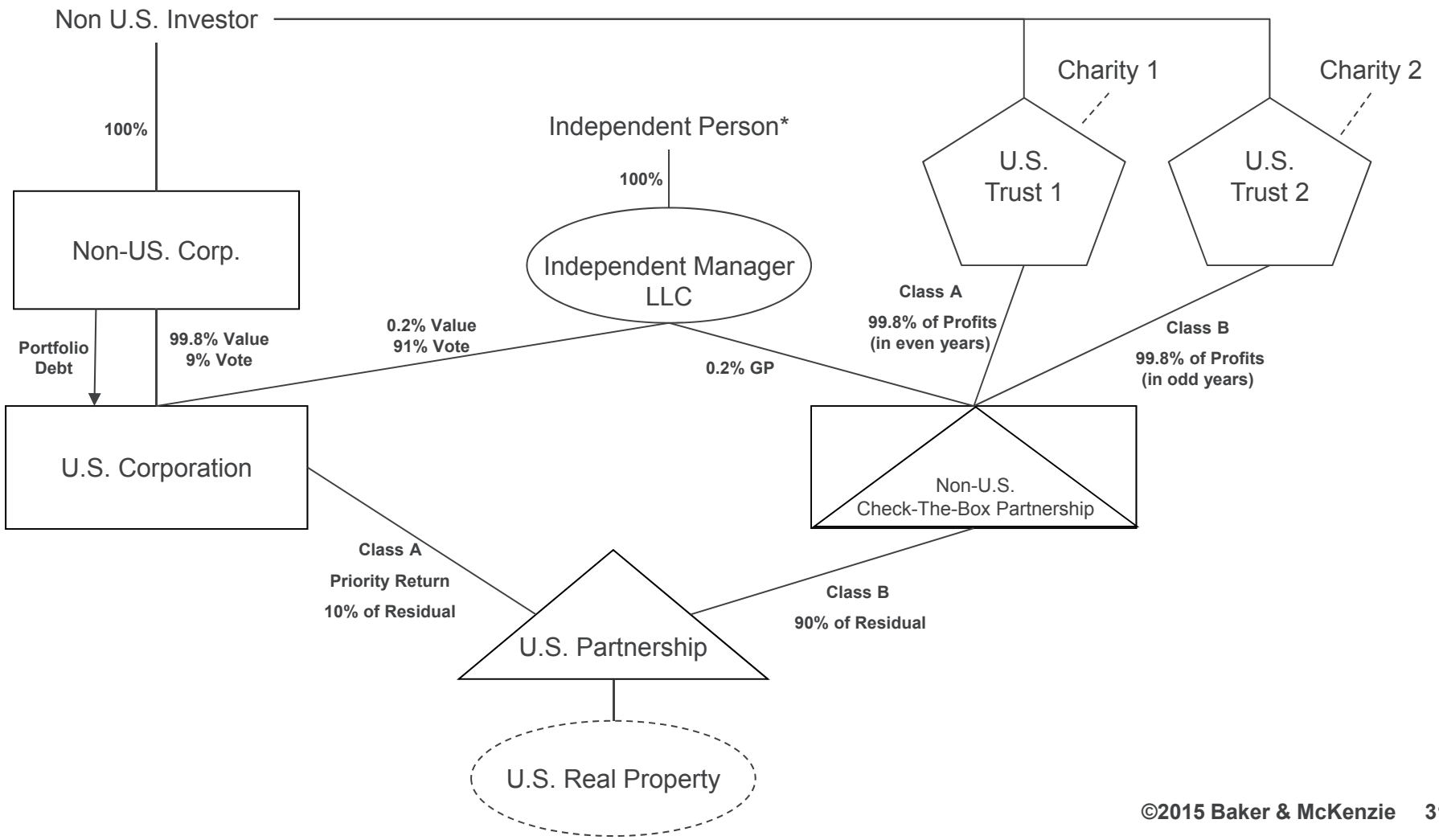
MORE COMPLEX INVESTMENT STRUCTURES FOR NON-U.S. INDIVIDUAL INVESTORS

- Leveraged Blocker With Portfolio Debt Structure.
- Dual Trust Structure.

Leveraged Blocker With Portfolio Debt Structure

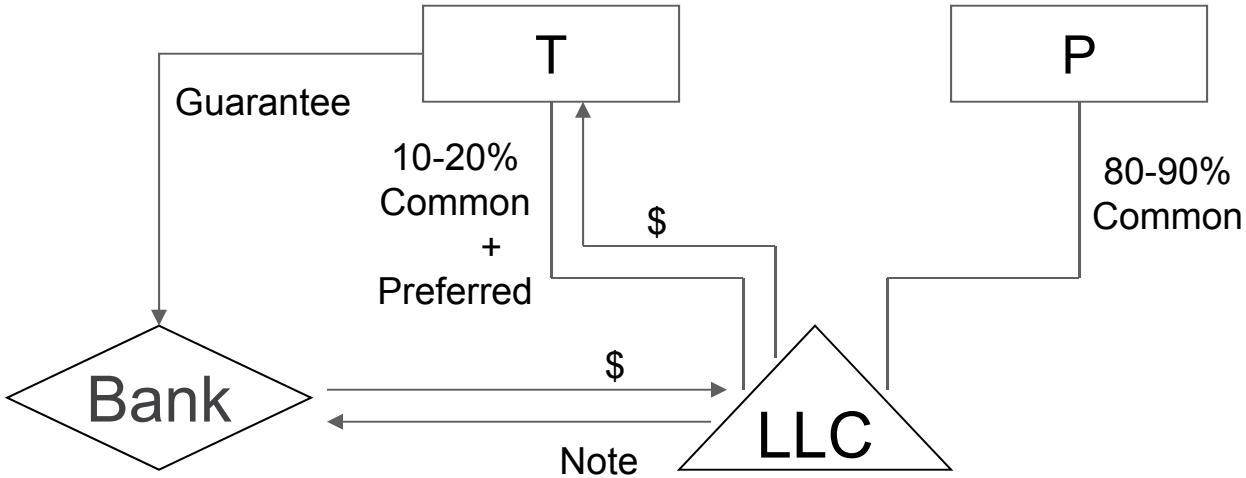


Dual Trust Structure



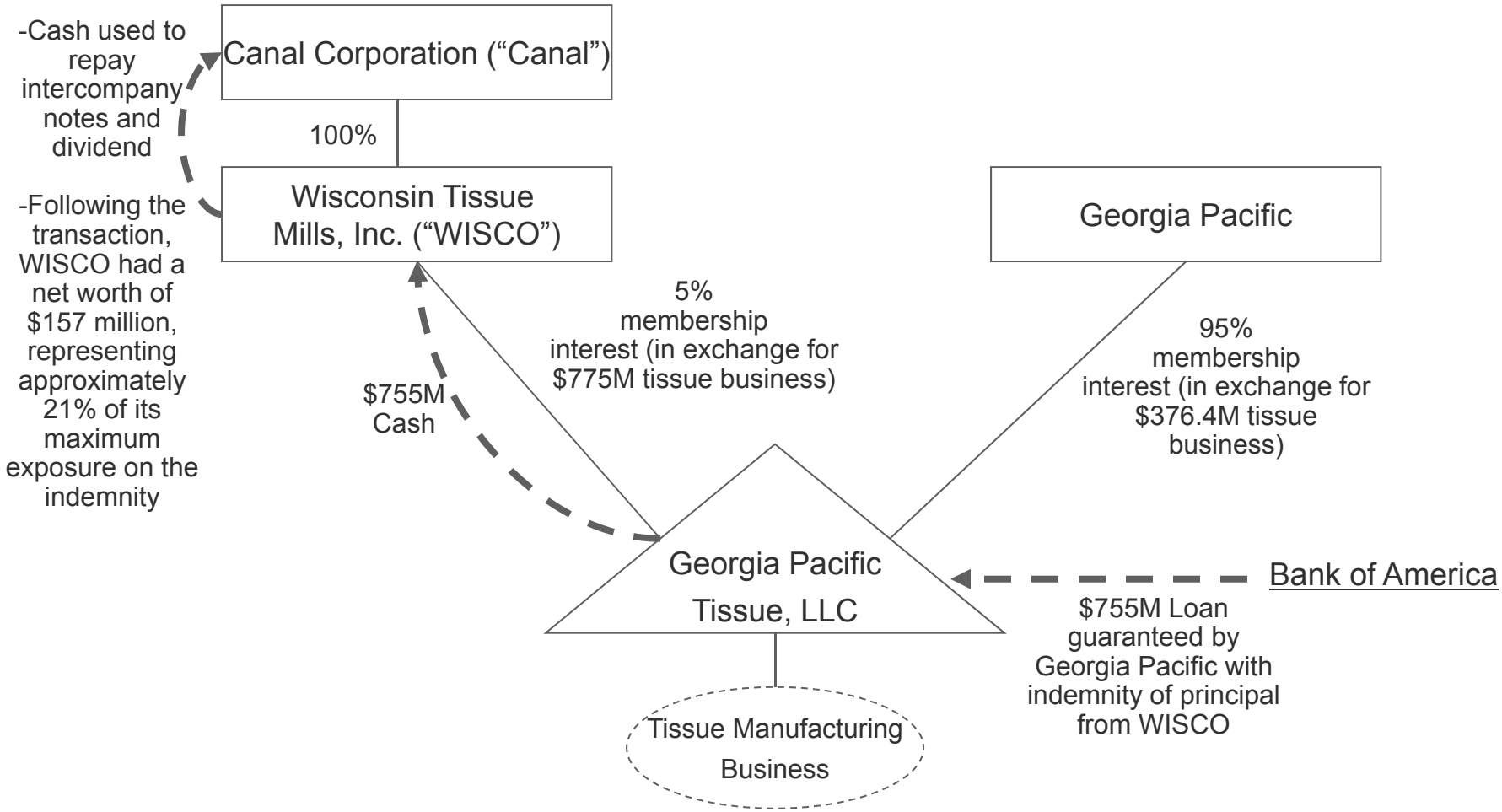
LEVERAGED PARTNERSHIP / DISGUISED SALES

Typical Leveraged Partnership / Disguised Sales



- LLC borrows money from Bank. T guarantees the loan
- T's guarantee ensures that the liability is allocated to T
- LLC distributes loan proceeds to T
- T should not recognize gain under the disguised sale rules, and has sufficient basis so that the cash distribution is tax-free

Canal Transaction



IRC CODE SECTION 1031

LIKE-KIND EXCHANGE STRATEGIES

A Frequently Encountered Problem

- It is exceedingly common when a partnership sells its property that one or more of the partners want to cash out in the transaction, whereas other partners want to reinvest through a like-kind exchange.

Example

- Jack, Karen, Luke, and Mary are equal partners in partnership JKLM, the only asset of which is Whiteacre, a rental apartment building worth $10 million. Jack inherited his interest from his recently deceased parent, and Karen contributed $2.5 million to JKLM (which the partnership used for capital improvements) for her interest, so they each have a stepped-up basis in their partnership interests. Luke and Mary have a zero basis in their interests. JKLM made a Section 754 election, so the partnership has a $5 million basis in Whiteacre.
- A buyer has offered to purchase Whiteacre for its FMV of $10 million, and all of the partners want to sell. Jack and Karen either want to cash out with their share of the proceeds of the sale or, at a minimum, separate from the other partners, but Luke and Mary want JKLM to purchase replacement property so as to defer gain recognition.

Example (continued) – The Issue

- If JKLM sells Whiteacre to the buyer and half of the proceeds are given to a QI and half are received by JKLM in cash (for distribution to Jack and Karen), the partnership will recognize $5 million of gain on the transaction, because gain is recognized to the extent of the boot received ($5 million in cash). If this gain were allocated equally to all of the partners, Luke and Mary would each recognize $1.25 million of gain but receive none of the cash; needless to say, this result would not be acceptable.

Four alternatives for resolving this situation:

- Special allocations.
- Distribution of undivided interests.
- Installment notes.
- Purchase of interests.

Special Allocations

- Some partnerships have attempted to use a special allocation of the gain to the partners who cash out, i.e., the $5 million gain would be allocated to Jack and Karen.
- This gain would increase their basis in their partnership interests, so Jack and Karen also would have offsetting capital losses on the receipt of $2.5 million each from JKLM in redemption of their interests.
- Of course, if any of the gain reflects depreciation recapture, Jack and Karen would have ordinary income and capital losses, which would not offset, resulting in adverse tax consequences.

Special Allocations

- Because special allocations of cash and mortgage relief boot to certain partners in a partnership often will not be in accordance with the partners' interests in the partnership, special allocations are of limited use for partners looking to cash out of the partnership's ownership of relinquished property in a like-kind exchange.

Distribution of Undivided Interests

- Assuming that gain cannot be specially allocated to the cash-out partners, many partnerships have distributed undivided tenancy-in-common ("TIC") interests in the property to their partners immediately before the sale.
- In our example, JKLM would distribute 25% undivided interests in Whiteacre to Jack and Karen in redemption of their interests immediately before the sale, while Luke and Mary would remain partners in the partnership.
- Alternatively, undivided interests could be distributed to all of the partners in a liquidation of the partnership immediately before the sale of the relinquished property to the buyer.
- However, two issues arise under both options, and a third issue arises in the alternative option.

Distribution of Undivided Interests – The Issues

- Notwithstanding the distribution of the undivided interest to Jack and Karen (or the dissolution of JKLM, in the alternative scenario), does the relationship between the partners constitute a deemed partnership under Section 761, particularly if there is a significant level of activity involved in the operation and management of Whiteacre?
- How did the property transfer relate to the timing of the transfer of the undivided interests in the property? Did the partnership previously sign a contract to sell the property? If it did, then the IRS could argue, relying on *Court Holding Company,* 33 AFTR 593 324 US 331 89 L Ed 981 1945 CB 58 (1945), that under step-transaction principles, the transaction must be viewed as a sale of the property by the partnership, the intervening distribution notwithstanding.
- In the alternative scenario where JKLM is dissolved, a third issue is whether the partners satisfy Section 1031's "held for use in a trade or business or for investment" test if they receive their undivided interests immediately before the exchange?

Installment Notes

- Under this approach, the buyer conveys to the seller cash to be used for the purchase of the replacement property plus an installment note that could be distributed to the cash-out partners in liquidation of their interests.
- Applying this method to our example, JKLM would convey the relinquished property to a QI. Then, the buyer would convey to the QI, in exchange for the relinquished property, cash of $5 million plus an installment note for $5 million.
- The QI would use the $5 million in cash to purchase replacement property and then transfer the replacement property and the note to JKLM, which would then distribute the note to Jack and Karen in liquidation of their interests.
- The note typically would provide for 98% or 99% of the payments thereon to be made a short time after closing, with the remaining payments to be made after the beginning of the next tax year, thus qualifying for installment reporting under Section 453(b)(1).

Installment Notes

- This method works because no gain or loss is recognized by JKLM on receipt of the installment note (although there are certain exceptions to nonrecognition under Section 453, such as sales of inventory and depreciation recapture).
- With respect to the remainder of the transaction, JKLM, now comprising only the remaining two partners (Luke and Mary), would not recognize any gain on JKLM's receipt of the replacement property because the partnership had held the relinquished property and, through the QI, acquired the replacement property in a like-kind exchange.

Installment Notes – Note from the QI?

- What if the buyer is unwilling to issue its note, or the seller of the property is unwilling to accept the buyer's note (even if the note is backed by a standby letter of credit)?
- In that event, it is important to consider that the party with whom the taxpayer is engaging in an exchange is the QI, and not the ultimate buyer of the relinquished property. Therefore, the taxpayer could arguably accomplish the same result by receiving an installment note from the QI. Provided that this note is not collateralized by cash or other liquid assets, the QI's note should be just as effective as a note from the buyer, and it often will be easier to arrange for.
- However, at a recent ABA Tax Section meeting a Treasury and an IRS official questioned whether an installment note from the QI could work, because it could be extending the 'artificial' construct of the QI too far beyond what was intended (i.e., solely a like-kind exchange mechanism).

Purchase of Interests - Partner Buyout

- What if a partnership is not able to distribute undivided fractional interests to its partners before signing a sale contract (or is unwilling to actually record the transfer for transfer tax reasons), and the installment note transaction cannot be engineered for one reason or another?
- In that situation, the partners who desire to complete the exchange should consider buying the interests of the cash-out partners immediately before the exchange.

Coordinated Like Kind Exchanges

- In some instances, the partners are willing to engage in like-kind exchanges but cannot agree on the replacement property to be acquired.
- Example: Partnership ("RST") owns Blackacre (the relinquished property), which is to be sold for $300. Partners R, S, and T each want to engage in a like-kind exchange, except that R wants to acquire only Redacre, S wants to acquire only Silveracre, and T wants to acquire only Tealacre and none of the partners is willing to be flexible in this regard. Each of the properties desired as replacement property costs $200.

Coordinated Like Kind Exchanges

- In this situation, RST could sell Blackacre and form three separate single-member LLCs-one for acquiring Redacre (“RLLC”), one for Silveracre (“SLLC”), and one for Tealacre (“TLLC”).
- R, S, and T can be appointed as the managing members of RLLC, SLLC, and TLLC, respectively. Moreover, because the proceeds of the sale of Blackacre ($300) are insufficient to pay for the purchase of all three replacement properties, R, S, and T can each lend $100 to RLLC, SLLC, and TLLC, respectively (or they can guarantee the loans used by each entity to acquire its replacement property).
- After a significant holding period, the partnership could dissolve, distributing RLLC to R, SLLC to S, and TLLC to T.

Coordinated Like Kind Exchanges – The Rub

- This transaction works, however, only if partnership RST is the tax owner of the replacement properties acquired through the newly formed LLCs.
- To achieve this result, the partners (R, S, and T) have to continue to share in the economic performance, as well as the appreciation and depreciation, of each of the properties owned by RST.
- The partners will likely seek special or tracking allocations of the income and gain from the properties; this urge needs to be resisted so as to give each of the partners a real economic interest in all of the properties owned by RST.

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