2005

Disposing of Overleveraged Real Estate: Thinking Outside the Box

Blake D. Rubin

Andrea Macintosh Whiteway

Repository Citation
https://scholarship.law.wm.edu/tax/124
DISPOSING OF OVERLEVERAGED REAL ESTATE:
THINKING OUTSIDE THE BOX

By
Blake D. Rubin and Andrea Macintosh Whiteway
Arnold & Porter LLP, Washington, D.C.

September 2005

TABLE OF CONTENTS

I. INTRODUCTION ...................................................................................................1

II. MODEL FACT PATTERN .....................................................................................1

III. ALTERNATIVE 1: OUTRIGHT SALE .................................................................2

A. Proposed Transaction.........................................................................................2

B. Consequences of Outright Sale........................................................................2

IV. ALTERNATIVE 2: INSTALLMENT SALE ............................................................2

A. Generally........................................................................................................2

B. Proposed Transaction.......................................................................................3

C. Consequences of Installment Sale..................................................................3

V. ALTERNATIVE 3: INSTALLMENT SALE WITH WRAPAROUND
MORTGAGE.............................................................................................................4

A. Generally........................................................................................................4

B. Proposed Transaction.......................................................................................6

C. Consequences of Installment Sale With Wraparound Mortgage..................6

D. Interest Charge On Deferred Installment Sale Gain .....................................6

VI. ALTERNATIVE 4: PARTNERSHIP ADMISSION WITH BOOK-UP ..................7

A. Section 704(b) - Allocation of Book Items Attributable to Revalued Property .................................................................7

B. Section 704(c) - Allocation of Tax Items Attributable to Revalued Property .................................................................9

Copyright 2005 Blake D. Rubin and Andrea Macintosh Whiteway. All rights reserved
C. Partner’s Share of Partnership Liabilities ............................................... 11
D. Section 754 Election .............................................................................. 13
E. Proposed Transaction ........................................................................... 13
F. Consequences of Partnership Admission With Book-Up and Traditional Method ................................................................................. 14
G. Consequences of Partnership Admission With Book-Up and Curative Allocation Method ........................................................................ 16
H. Consequences of Partnership Admission With Book-Up and Remedial Allocation Method ................................................................. 17

VII. ALTERNATIVE 5: PARTNERSHIP ADMISSION WITH NO BOOK-UP TRANSACTION .................................................................................. 19
A. Generally .............................................................................................. 19
B. Proposed Transaction ........................................................................... 20
C. Consequences of Partnership Admission With No Book-Up .............. 20

VIII. CONCLUSION .................................................................................... 20
DISPOSING OF OVERLEVERAGED REAL ESTATE: THINKING OUTSIDE THE BOX

By
Blake D. Rubin and Andrea Macintosh Whiteway
Arnold & Porter LLP, Washington, D.C.

I. INTRODUCTION

A. One scenario that frequently arises in the real estate workout context is as follows: The taxpayer — typically a partnership — owns real property with a low basis subject to nonrecourse debt in an amount equal to or in excess of value. The debt may be close to maturity or in default, and, in the absence of a consensual transaction, foreclosure is likely to occur in the reasonably near future. The taxpayer has located a buyer for the property, but of course the purchase price will not result in any cash proceeds to the taxpayer. The buyer has identified a new lender who is willing to provide new financing in order to take out the existing lender. The existing lender may agree to accept a discounted pay-off on the debt.

B. If the taxpayer does not consummate the transaction, foreclosure will occur, with its attendant disastrous tax consequences. The challenge faced by the tax planner is to structure a consensual transaction with the buyer in a manner that will transfer effective economic ownership to the buyer while deferring the taxpayer’s gain.

C. This outline explores the tax consequences to the seller and the buyer of various structures for the disposition of overencumbered real estate. A single fact pattern is used to analyze, illustrate and compare the results of using the various structures.

D. The various structures analyzed herein include an outright sale of the property subject to the debt; an installment sale and an installment sale using a wraparound mortgage; and the use of a partnership between the seller and buyer either with or without a “book-up”, including an analysis of the differing tax consequences of the three allocation methods available under Section 704(c) of the Internal Revenue Code of 1986, as amended.

II. MODEL FACT PATTERN

A. The following fact pattern (“Fact Pattern”) will be used throughout this article to explore the consequences of using various alternative structures for the disposition of overleveraged real estate.

1 Copyright 2005 Blake D. Rubin and Andrea Macintosh Whiteway. All rights reserved.
B. Taxpayer A, a partnership, owns real property with an adjusted tax basis of $40, and a fair market value of $100. The property is subject to a mortgage in the amount of $99. The principal due on the mortgage is payable over 10 years in equal annual installments of $9.90. The entire $40 basis is depreciable and has a remaining statutory recovery period of 10 years. If the property were newly placed in service, it would have a statutory recovery period of 39 years. The impact of the "mid-month convention" of Section 168(d) of the Code is ignored. It is assumed that the value and basis of any land and personal property at the site is $0. All gain on sale is "unrecaptured section 1250 gain" subject to a Federal tax rate of 25 percent. The property generates rental income each year exactly equal to its cash expenses. Thus, the property operates on a cash break-even basis, and generates a tax loss equal to the annual depreciation deduction.

III. ALTERNATIVE 1: OUTRIGHT SALE

A. Proposed Transaction. A sells the property to B for $1, with B taking the property subject to the $99 mortgage.

B. Consequences of Outright Sale

1. A will recognize $60 of gain on such sale. In the event of an outright sale of property with debt in excess of basis, gain will be recognized in the amount of the excess of the amount realized over the adjusted basis of the property. Section 1001. On the sale or other disposition of mortgaged property, the amount realized includes the amount of the mortgage liabilities from which the transferor is discharged as a result of the sale or disposition. Treas. Reg. § 1.1001-2(a)(1); Crane v. Comm’r, 331 U.S. 1 (1947).

2. B will have a cost basis of $100 in the property and begin a new depreciable life of 39 years, allowing for annual depreciation deductions of $2.56 ($100 basis/39 years). Section 1012.

IV. ALTERNATIVE 2: INSTALLMENT SALE

A. Generally.

1. Section 453 provides rules for reporting gain from certain qualifying installment sales of property on the installment method. An installment sale is a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs. Section 453(b).

2. Where a disposition qualifies as an installment sale, the installment method permits a taxpayer to defer gain recognition on the sale until the taxpayer actually receives the installment payments. Each
payment represents both (i) a nontaxable recovery of a portion of the seller’s basis (investment) in the property, and (ii) a taxable realization of a portion of the seller’s gain. Only the amount of each payment that represents gain must be reported as income.

3. Key definitions under installment reporting rules.

a. Selling Price - Where property subject to debt is sold on the installment method and the purchaser assumes, or takes the property subject to such debt, the selling price is defined to mean the gross selling price without any reduction for such debt. Temp. Treas. Reg. § 15A.453-1(b)(2)(ii).

b. Contract Price - The “contract price” is the selling price reduced by the amount of any “qualifying indebtedness” assumed or taken subject to by the buyer, to the extent of the seller’s basis in the property. Temp. Treas. Reg. § 15A.453-1(b)(2)(iii). The excess of debt assumed or taken subject to over the seller’s basis is treated as a payment received in the year of sale. Temp. Treas. Reg. § 15A.453-1(b)(3)(i). In every case where the amount of debt assumed or taken subject to exceeds the seller’s basis in the property, the seller will recover its entire basis in the year of sale. Moreover, the amount of debt assumed in excess of basis will be treated as a payment received in the year of sale, thereby increasing gain recognition in the year of sale.

c. Gross Profit - The gross profit ratio is the ratio of the gross profit to the total contract price. Temp. Treas. Reg. § 15A.453-1(b)(2)(v). In cases where the buyer assumes or takes subject to a mortgage in an amount greater than the seller’s basis in the property, the gross profit ratio will always be 100%.

B. Proposed Transaction - Assume A sells the property subject to the $99 mortgage, taking back an installment note in the amount of $1 payable over ten years in equal annual installments of $0.10.

C. Consequences of Installment Sale.

1. The gross profit on the sale is $60 ($100 selling price less $40 basis). The contract price is $60 ($100 selling price reduced by the lesser of the $99 qualifying indebtedness or A’s $40 basis). The gross profit ratio is 100% ($60 gross profit/$60 contract price); therefore, 100% of each installment received will be taxable as gain.
2. Payments in the year of sale will include the $0.10 actually received plus the $59 of mortgage debt taken subject to in excess of A’s basis. Accordingly, in year 1, A will have “unrecaptured section 1250 gain” of $59.10 representing the payment of $0.10 cash and the $59 of debt assumed by B in excess of A’s basis. Over the next nine years A will receive a total payment of $0.90, which will be fully taxable.

3. B will have a cost basis of $100 in the property and begin a new depreciable life of 39 years allowing for annual depreciation deductions of $2.56.

V. ALTERNATIVE 3: INSTALLMENT SALE WITH WRAPAROUND MORTGAGE

A. Generally.

1. A wraparound mortgage is an agreement in which the buyer issues to the seller an installment obligation in an amount that effectively includes the seller’s outstanding mortgage encumbering the property. As between the buyer and the seller, the seller remains liable for and continues to service the underlying mortgage.

2. Wraparound mortgages provide a mechanism for avoiding the provisions in the installment reporting regulations requiring the treatment of mortgage debt in excess of basis that is “assumed” or “taken subject to” as a deemed payment in the year of sale.

3. In Stonecrest Corp. v. Comm’r, 24 T.C. 659 (1955), nonacq., 1956-1 C.B. 6, the Tax Court concluded that wraparound notes were not subject to the regulations governing “subject to” and “assumed” sales, because by the very nature of the wraparound notes, the buyer neither “assumed” the underlying mortgage nor took “subject” to it. In Stonecrest, the seller retained legal title to the property as a security device, agreeing to apply the buyer’s installment payments to the underlying mortgage and convey title to the property to the buyer at a future time. The court treated the transaction as a sale for tax purposes notwithstanding the seller’s retention of title, but refused to find an assumption of the underlying mortgage or a conveyance subject to it. Accordingly, the excess of the mortgage over the seller’s basis was not includible as a payment deemed received in the year of sale.

A wraparound mortgage was generally treated as having assumed or taken the property subject to the seller’s mortgage, even though title had not passed to the buyer and, as between seller and buyer, the seller remained liable for payments on the mortgage. Temp. Treas. Reg. § 15A.453-1(b)(3)(ii). Therefore, under the Temporary Regulations, where the debt exceeds the seller’s basis in the property, such excess was treated as a payment in the year of sale.

5. In 1987, the Tax Court held Temp. Treas. Reg. § 15A.453-1(b)(3)(ii) invalid as inconsistent with Section 453(c). In Professional Equities, Inc. v. Comm’r, 89 T.C. 165 (1987), the Service challenged the taxpayer’s computation of the total contract price where the taxpayer used wraparound mortgages. The IRS argued that the taxpayer must reduce the contract price by the mortgage in accordance with Temp. Treas. Reg. § 15A.453-1(b)(3)(ii), whereas the taxpayer argued that the contract price represented the sales price used in computing gross profit and that the temporary regulations were invalid. In holding the temporary regulations as invalid, the Tax Court stated that for installment sales of property with a wraparound mortgage, the buyer should not be treated as taking the property subject to or having assumed the existing mortgage. Therefore, the seller should not have to reduce the total contract price by the amount of the underlying mortgage for the purpose of computing the percentage of a payment reportable as gain. The taxpayer was entitled to report gain from the wraparound sales under the method approved in Stonecrest. The IRS has acquiesced in the Tax Court’s decision in Professional Equities, AOD, 1988-2 C.B. 1. Nevertheless, the portion of the temporary regulations dealing with wraparound mortgages has not yet been withdrawn.

6. Notwithstanding the holding in Professional Equities, there are practical and tax risks associated with using a wraparound mortgage. Installment sales utilizing wraparound mortgages are often difficult to arrange in a satisfactory way because of the difficulty of providing the buyer with adequate assurances that its payments will reduce the underlying first mortgage (which remains a lien on the buyer’s property) without causing the wraparound arrangement to fail from a tax perspective.

7. Even if a transaction is characterized as a wraparound mortgage, it will not be taxed as such if in substance the buyer has taken the property subject to the underlying mortgage. This will occur if either the buyer is required to discharge the underlying mortgage or the seller has so little control over disposition of the payments made by the buyer that in fact, the payments are in substance being
made directly from the buyer to the first mortgagee. See Goodman v. Comm'rs, 74 T.C. 684 (1980), aff'd without pub. op. 673 F.2d 1332 (7th Cir. 1981). In Kline v. Comm'r, T.C. Memo. 1989-317, citing Goodman v. Comm'r, the court concluded that the use of a collection account to provide assurances that the buyers payments would in turn be used to service the mortgage indicated that the seller had given up sufficient control over the proceeds of the wraparound note that the buyer must be treated as having assumed the mortgage.

B. Proposed Transaction - Assume A sells the property to B, taking back a $100 all-inclusive “wraparound” note secured by a second mortgage. The wraparound note requires payments of principal of $10 per year. Although the $99 first mortgage remains a lien on the property, the wraparound documents obligate A, rather than B, to make all payments of principal and interest as and when due on the first mortgage.

C. Consequences of Installment Sale With Wraparound Mortgage.

1. Assuming the wraparound mortgage is respected, A’s gross profit is $60 ($100 selling price less $40 basis), and the contract price is $100 (i.e., there is no reduction for the underlying mortgage). Therefore, the gross profit ratio for the payments received each year is 60% ($60 divided by $100). Payments in the year of sale equal $10 (there is no $59 deemed payment for the amount of mortgage assumed that is greater than basis).

2. A must recognize $6 (60% of $10) of gain in year 1. In each of years 2 through 10, A will receive annual payments of $10, and $6 of each payment will be taxable gain. In each year, A will have to apply $9.90 for principal amortization on the underlying, and will get to keep $.10.

3. B will take a cost basis of $100 in the property and be entitled to annual depreciation deductions of $2.56 over the 39 year depreciable life of the property.

D. Interest Charge On Deferred Installment Sale Gain

1. A major disadvantage of using an installment sale with a wraparound mortgage is the application of the interest charge rules. Because installment reporting effectively permits taxpayers to receive an interest-free loan from the government in an amount equal to the unpaid tax due on the sale, the Revenue Act of 1987, Pub. L. No. 100-203, §10202(c)(i), imposed an interest charge on the deferral of tax attributable to the installment sale by nondealer sellers of real estate. Application of this interest charge was
extended to virtually all nondealer installment sales pursuant to the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647.

2. The interest charge is imposed on the tax that is otherwise deferred by use of the installment obligation. Interest is due on the deferred tax where the face amount of all applicable installment obligations that arose during the tax year and that are outstanding as of the close of the tax year exceeds $5 million. Section 453A(a) and (b).

3. Partnerships apply the $5 million threshold at the partner level. Notice 88-81. Therefore, a partner will not be subject to the interest charge if its share of the partnership’s installment obligations arising in the year, plus any installment obligations of the partner arising outside the partnership during the year, do not exceed $5,000,000.

4. The interest charge is calculated by reference to the “applicable percentage” of the deferred tax liability with respect to the installment obligation, multiplied by the underpayment rate under Section 6621 at year end. For purposes of this computation, the deferred tax liability is that amount of gain that has not been recognized as of the close of the tax year, multiplied by the maximum rate of tax applicable to the taxpayer.

5. Under Section 453A(c)(1), the interest charge is payable in the same manner as tax for the year. This implies that interest charges must be taken into account in making estimated tax payments.

6. Under Section 453A(c)(5), the amount payable as an interest charge is treated as interest in computing the amount of any deduction for interest paid or accrued during the year.

7. In the context of a wraparound mortgage, it appears likely that for purposes of determining whether the $5,000,000 threshold has been met, the taxpayer is stuck with his own form and must take into account the entire amount of the wraparound obligation, rather than merely the amount of the wrap in excess of the underlying.

VI. ALTERNATIVE 4: PARTNERSHIP ADMISSION WITH BOOK-UP

A. Section 704(b) - Allocation of Book Items Attributable to Revalued Property

1. Section 704(b) provides that the allocation of the items of income, gain, loss, deduction or credit must have substantial economic effect or the amounts will be reallocated in accordance with the partners’ interests in the partnership.
2. The regulations under Section 704(b) contain a “safe harbor” that includes capital account maintenance rules that require positive capital account adjustments reflecting “partnership income and gain (or items thereof)” and negative capital account adjustments reflecting “partnership loss or deduction (or items thereof).” Under the safe harbor, allocations will be respected if they have “substantial economic effect.”

3. The substantial economic effect test will be satisfied if: (1) a partnership allocation has economic effect; and (2) the economic effect is substantial. Treas. Reg. § 1.704-1(b)(2). Generally, an allocation will have economic effect only if the partnership agreement provides that:

   a. the partners’ capital accounts are determined and maintained in accordance with the capital accounting rules provided in the regulations;

   b. liquidation proceeds are to be distributed in accordance with the partners’ positive capital account balances; and

   c. a partner is unconditionally obligated, following liquidation of his partnership interest, to restore any deficit balance in his capital account to the partnership by the end of the tax year, or, if later, within 90 days after the date of liquidation. Treas. Reg. § 1.704-1(b)(2).

   d. Alternatively, under certain circumstances, partnership allocations may have economic effect even though the third requirement is not met if the partnership agreement contains a “qualified income offset” provision. Treas. Reg. § 1.704-1(b)(2)(ii)(d).

   e. Special rules apply with respect to the allocation of “nonrecourse deductions” and “partner nonrecourse deductions”. See Treas. Reg. § 1.704-2. Treas. Reg. § 1.704-1(b)(2)(iv)(f) provides a mechanism by which the capital accounts of partners can be increased or decreased to reflect a revaluation of partnership property on the partnership’s books. Where partnership property is subject to nonrecourse debt, any such revaluation of encumbered property is based on the greater of the fair market value of the property or the amount of the nonrecourse debt outstanding immediately following the exchange. After a revaluation, tax items arising from the property must be shared among the partners in a manner similar to Section 704(c). Treas. Reg. § 1.704-1(b)(4)(i).
f. Pursuant to these regulations, the partnership may restate the existing partners' capital accounts upon the entry of a new partner, by revaluing the partnership's property to its fair market value in order to reflect unrealized gain, loss, income or deduction inherent in the property which would be allocated to the existing partners if the property were disposed of in a taxable transaction in exchange for an amount equal to its fair market value as of the date of the new partner's capital contribution. This restatement of capital accounts ensures that the new partners will not share in pre-contribution appreciation or depreciation in value of the partnership's assets.

B. Section 704(c) - Allocation of Tax Items Attributable to Revalued Property

1. Section 704(c) generally requires that any built-in gain or loss (i.e., difference between value and basis) inherent in property at the time of its contribution to a partnership or at the time of its revaluation must be allocated to the contributing partner (or partners whose capital accounts are increased in the revaluation) when the built-in gain or loss is recognized. Moreover, the allocation of cost recovery deductions must take into account built-in gain or loss on the property. In general, the rules require that the noncontributing partner be put in the same position it would have been if had the property had basis equal to value. Put differently, to the extent possible, the noncontributing partner must be allocated cost recovery deductions for tax purposes equal to its book allocation of cost recovery deductions.

a. The amount of built-in gain or loss that must be allocated to a partner under Section 704(c) at any point in time is equal to the difference between its "book" basis and its tax basis. Treas. Reg. § 1.704-3(b)(3)(ii).

2. Traditional Method

a. Treas. Reg. § 1.704-3(b) sets forth the traditional method of making Section 704(c) allocations. Under the traditional method, the "ceiling rule" applies.

b. The ceiling rule prevents the partnership from allocating tax cost recovery deductions to partners that exceed the total cost recovery deductions attributable to that property. Treas. Reg. § 1.704-3(b)(1). As a result of the ceiling rule, a noncontributing partner may not be able to receive tax depreciation deductions on the contributed or revalued
property equal to the deductions it would have received if the property had basis equal to value.

3. Traditional Method with Curative Allocations
   
a. Treas. Reg. § 1.704-3(c) sets forth the rules governing application of the traditional method with curative allocations. This method is designed to correct distortions that are created by application of the ceiling rule in the traditional method.

b. Under the traditional method with curative allocations, the partnership is permitted to reduce or eliminate book/tax disparities of the noncontributing partners by making “curative” allocations of other items of income, gain, loss or deduction.

c. When a noncontributing partner is allocated less tax depreciation than book depreciation with respect to an item of Section 704(c) property, the partnership may make a curative allocation to that partner of tax depreciation from another item of partnership property to make up the difference, notwithstanding that the corresponding book depreciation is being allocated to the contributing partner. Moreover, a partnership may limit its curative allocations to allocations of one or more particular tax items (e.g., only depreciation from specific property) in spite of the fact that these allocations do not offset fully the effect of the ceiling rule. Curative allocations do not affect the partners’ book capital accounts.

4. The Remedial Allocation Method
   
a. Treas. Reg. § 1.704-3(d) sets forth the rules governing remedial method of making Section 704(c) allocations. This method is designed to eliminate any book/tax disparity in allocations of partnership items regardless of the availability of partnership items to allocate.

b. The remedial allocation method eliminates the disparity through “creating” and allocating remedial items. Unlike curative allocations, the remedial allocations are not limited by actual items of income, gain, loss or deduction in the partnership.

c. In calculating the amount of the book items attributable to the contributed property, the partnership’s book basis (to the extent of adjusted tax basis) is recovered in the same
manner as the adjusted tax basis, over the property’s remaining recovery period, with the excess book basis being recovered using the depreciation method otherwise used by the partnership for newly acquired property that is placed in service on the date of contribution.

d. Remedial allocations have the same tax attributes as the tax item to which they apply, limited by the ceiling rule. Therefore, if the ceiling rule limited item is depreciation from property used in a rental activity, the remedial allocation to the noncontributing partner is depreciation from property used in a rental activity and the offsetting remedial allocation to the contributing partner is ordinary income from that rental activity.

e. Remedial allocations do not affect the partners’ book capital accounts. Remedial allocations affect a partner’s adjusted tax basis in the partnership interest in the same manner as do actual tax items.

C. Partner’s Share of Partnership Liabilities

1. Section 752 and Treas. Reg. §1.752-3 Generally

a. The admission of new partners to a partnership can result in a shift of liability from the historic partners to the new partners. Where there is a liability shift, it decreases the historic partners' bases in their partnership interest and increases the new partner’s bases in its partnership interests. The shift in liability can also result in gain recognition to the historic partners.

b. Pursuant to Section 752(b) any decrease in a partner’s share of the liabilities of a partnership, or any decrease in a partner’s individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be treated as a distribution of money to the partner by the partnership. The regulations promulgated under Section 752 set forth rules for determining a partner’s share of nonrecourse liabilities. Treas. Reg. § 1.752-3 provides that a partner’s share of partnership nonrecourse liabilities equals the sum of (1) a partner’s share of partnership minimum gain determined pursuant to Section 704(b) (the “First Tier”), (2) the amount of any taxable gain that would be allocated to the partner under Section 704(c) (or in the same manner as under Section 704(c) if partnership property is revalued) if the partnership disposed of all
partnership property subject to nonrecourse liabilities for no consideration other than full satisfaction of the liabilities (the "Second Tier"), and (3) the partner’s share of the excess nonrecourse liabilities determined in accordance with the partner’s share of partnership profits (the "Third Tier"). Treas. Reg. § 1.752-3(a).

c. The amount computed under the Second Tier is sometimes referred to as “Section 704(c) minimum gain.” Where the contributed property is depreciable, the amount of Section 704(c) minimum gain (and therefore the Second Tier allocation of debt) is reduced over time as book and tax depreciation deductions are claimed. When the property is fully depreciated, Section 704(c) minimum gain and the Second Tier allocation will be reduced to zero.

2. Interaction of Section 704(c) and the Allocation of Nonrecourse Liabilities

a. Rev. Rul. 95-41, 1995-1 C.B. 132, explains how Section 704(c) affects allocations of nonrecourse liabilities under Treas. Reg. § 1.752-3(a). Allocations under the First Tier are not affected by Section 704(c). Allocations under the Second Tier take into account remedial allocations of gain that would be made to the contributing partner under Treas. Reg. § 1.704-3(d), but do not take into account curative allocations under Treas. Reg. § 1.704-3(c).

b. Under the Third Tier, if the partnership determines the partners’ interests in partnership profits based on all the facts and circumstances relating to the economic arrangement of the partners, Section 704(c) built-in gain that was taken into account under the Second Tier is one factor, but not the only factor, to be considered under the Third Tier. If the partnership chooses to allocate excess nonrecourse liabilities in a manner reasonably consistent with allocations (that have substantial economic effect under the Section 704(b) regulations) of some other significant item of partnership income or gain, Section 704(c) does not affect the allocation of nonrecourse liabilities under the Third Tier because Section 704(c) allocations do not have substantial economic effect. Finally, if the partnership chooses to allocate the Third Tier in accordance with the manner in which it is reasonably expected that deductions attributable to the nonrecourse debt will be allocated, the partnership must take into account the Section 704(c) allocations in determining the
manner in which the deductions attributable to the nonrecourse liabilities will be allocated.

c. The importance of the holding of Rev. Rul. 95-41 regarding the impact of Section 704(c) in determining the Third Tier allocation has been eclipsed by the rule in Treas. Reg. § 1.752-3(a)(3) allowing the Third Tier to be allocated first to a partner up to the amount of built-in gain allocable to such partner not taken into account in the Second Tier, which was added by an amendment to Treas. Reg. § 1.752-3(a)(3) issued October 30, 2000.

D. Section 754 Election

1. The gain resulting from a Section 752 shift in liabilities does not affect the partnership's basis in its assets, unless the partnership has made a Section 754 election. Pursuant to Section 754, a partnership may elect to adjust the basis of partnership property in the case of a distribution of property or in the case of a transfer of a partnership interest. The election is applicable in the case of a Section 752 deemed distribution that results in the recognition of gain under Section 731(a)(1). The election applies with respect to all distributions of property by the partnership and to all transfers of interests in the partnership during the taxable year with respect to which the election was filed and all subsequent taxable years.

2. Section 731(a)(1) provides that a partner shall recognize gain to the extent that any money distributed to the partner (or deemed distributed) exceeds the adjusted basis of such partner’s interest in the partnership immediately before the distribution. When a Section 754 election has been made, there is an optional basis adjustment under Section 734(b).

3. Section 734(b) provides that when a partner recognizes gain as a result of a distribution of money that exceeds basis under Section 731(a), the partnership’s basis in its assets shall be increased by the amount of such gain. This adjustment takes into account that a partner has recognized a portion of the partnership’s gain and prevents the other partner from recognizing the gain again.

E. Proposed Transaction In order to simplify computations, vary the Fact Pattern slightly and assume that the principal amount due on the nonrecourse debt is $100 rather than $99, and that the entire principal amount is due at the end of 10 years. A's old partners (collectively, “OP”) have a capital account in A equal to ($60). B makes a capital contribution of $1 and acquires a 99% interest in the partnership. The partnership
F. Consequences of Partnership Admission With Book-Up and Traditional Method

1. Assume that A will make allocations under Section 704(c) principles using the traditional method under Treas. Reg. § 1.704-3(b).

2. Allocation of tax depreciation

   a. The property will continue to be depreciated over the remaining depreciable life of 10 years. B would have been entitled to a depreciation deduction of $9.90 ($100/10 years x 99%) per year for both book and tax purposes, if the adjusted tax basis of the property equaled its fair market value at the time of contribution. Although B is allocated $9.90 of book depreciation, the partnership is allowed a tax depreciation deduction of only $4 per year ($40/10 yrs). The ceiling rule prevents B from receiving the full $9.90 tax depreciation deduction, because the partnership can allocate only $4 of tax depreciation. The entire $4 is allocated to B. At the end of year 1, the book value of the property is $90 ($100 less the $10 book depreciation deduction), and the adjusted tax basis is $36 ($40 less the $4 tax depreciation deduction). OP's Section 704(c) gain with respect to the property decreases to $54 ($90 book value less $36 adjusted tax basis). Also, at the end of A's first year, OP has a ($10) book capital account and a ($60) tax capital account. B has a ($8.90) book capital account.

3. Shifting Liabilities

   a. Prior to B's admission, all $100 of the liability was includible in OP's basis. Prior to B's admission, Partnership A had $60 of partnership minimum gain, because if the partnership sold the property subject to the debt for no consideration other than to satisfy the liability there would be gain of $60 ($100 - $40). Treas. Reg. § 1.704-2(d)(1). Upon B's admission and the book-up, the $60 of minimum gain is reduced to $0 and $60 of Section 704(c) minimum gain is created under Treas. Reg. § 1.752-3(a)(2). OP's share of the liability after B's admission is reduced to $60.40 ($60 Section 704(c) minimum gain plus
1% of the $40 excess nonrecourse liability).\(^2\) Thus, the portion of the nonrecourse debt shifted to B is $39.60 ($100-$60.40), and under Section 752(b) OP is deemed to receive a cash distribution in this amount. Because OP’s adjusted basis of $40 in its partnership interest immediately prior to the deemed distribution is in excess of the $39.60 deemed distribution, there is no taxable distribution to OP upon the admission of B. OP’s basis immediately afterward is $0.40 ($40-$39.60).

b. During the first year, book depreciation of $10 reduces the book basis to $90 and tax depreciation of $6 reduces the tax basis to $36. Therefore, the remaining Section 704(c) gain, and the amount of Section 704(c) minimum gain, decreases from $60 to $54. Concomitantly, partnership minimum gain of $10 is created (the excess of nonrecourse debt of $100 over the book basis of $90). OP’s share of the debt at the end of year 1 is the sum of (i) $.10, its share of partnership minimum gain ($10 x .01), plus (ii) $54, its share of Section 704(c) minimum gain, plus (iii) $.36, its share of excess nonrecourse liabilities ($36 x .01). Thus, OP’s total share of liabilities is $54.46, a decrease of $5.94 from its share of liabilities at the beginning of the year. This amount is a deemed distribution of cash under Section 752(b), triggering gain of $5.54 under Section 731(a)(1) ($5.94 deemed distribution less $.40 basis). Moreover, OP’s share of liabilities will be reduced by $5.94 for each of years 3 through 10, triggering capital gain in those amounts in those years.

c. As a result of the shift in OP’s share of liabilities and the deemed cash distribution under Section 752(b) that triggers gain under Section 731(b), assuming that A has made a Section 754 election, A will get an upward adjustment in the basis of the property pursuant to Section 734(b) in an amount equal to the gain recognized outside the partnership by OP. This amount will be depreciable over a 39 year period, and presumably inures to the benefit of OP.

\(^2\) This analysis and the analysis below of the impact of using different methods under Section 704(c) assumes that the Third Tier nonrecourse liability allocation is based on percentage interests in the partnership and does not take into account Section 704(c) gain in excess of the amount taken into account in the Second Tier. See Treas. Reg. § 1.752-3(a)(3).
effectively displacing a portion of its Section 704(c) gain. See Treas. Reg. § 1.704-1(b)(2)(iv)(m)(4).

4. Impact on B
   a. B is allocated the entire $4 tax depreciation for each of the first ten years. In an outright sale, B would only receive $2.56 of tax depreciation annually over a 39 year period.
   b. Thus, there is a substantial acceleration of depreciation deductions to B during the first 10 years.

G. Consequences of Partnership Admission With Book-Up and Curative Allocation Method
   1. Assume instead that A will make allocations under Section 704(c) principles using the curative method under Treas. Reg. § 1.704-3(c).
   2. Allocation of Tax Depreciation
      a. B should be entitled to a depreciation deduction of $9.90 per year for both book and tax purposes, but its share is limited to the partnership’s total annual depreciation deduction of $4. By making a curative allocation, $5.90 of gross income is allocated to OP that would otherwise be allocated to B (or in the alternative B could be allocated an extra $5.90 of deductions), provided that the partnership has gross income of at least $5.90. In either case, the net effect is to increase OP’s ordinary taxable income by $5.90 per year, and to decrease B’s by a like amount.
   3. Shifting Liabilities
      a. Although the curative allocation does not affect OP’s book capital account, it does increase its basis by $5.90 each year. As a result, there is no deemed Section 752(b) distribution in excess of basis in any year.
   4. Impact on B

3 There is at least a theoretical risk that the upward basis adjustment under Section 734(b) reduces the amount of Section 704(c) minimum gain, thereby triggering an additional deemed distribution under Section 752(b) and additional gain under Section 731(a). See Rubin and Whiteway, “A Code Sec. 754 Paradox: Basis Step-Up Triggers Gain Recognition in Contribution Transactions,” 2 Journal of Passthrough Entities No. 6 (1999).
a. B is allocated $10 of tax depreciation for each of the next ten years. In an outright sale, B would only receive $2.56 of tax depreciation annually over a 39 year period. Thus, there is nearly a fourfold acceleration of depreciation deductions.

H. Consequences of Partnership Admission With Book-Up and Remedial Allocation Method

1. Assume instead that A will make allocations under Section 704(c) principles using the remedial method under Treas. Reg. § 1.704-3(d).

2. Allocation of Tax Depreciation

   a. Under the remedial allocation method, A has book depreciation for each of the remaining 10 years of $5.54 [$4 ($40 adjusted tax basis divided by the 10-year remaining recovery period) plus $1.54 ($60 excess of book value over tax basis, divided by the new 39-year recovery period)]. B is allocated $5.48 (99% of $5.54) of the book depreciation for each year of this 10 year period. OP is allocated $.06 of book depreciation. B is allocated all $4.00 of annual tax depreciation during this period.

   b. Because the ceiling rule would cause an annual disparity of $1.48 between B’s allocations of book and tax depreciation, A must make a remedial allocation of $1.48 of deductions to B for each of these ten years. A must also make an offsetting remedial allocation to OP of $1.48 of taxable income, which must be of the same type as income produced by the property. Treas. Reg. § 1.704-3(d)(1). For each of years 11 through 39, A has $1.54 of book depreciation ($60 excess of initial book value over adjusted tax basis divided by the 39-year recovery period that commenced in year 1), but no tax depreciation. Adjusted basis has been reduced from $40 to zero as a result of depreciation deductions during the first ten year period. B would be allocated $1.52 (99% of $1.54) of book depreciation and OP would be allocated the remaining $.02. The ceiling rule would apply because B would be allocated $1.52 of book depreciation, but no tax depreciation. This annual disparity of $1.52 between B’s allocations of book and tax depreciation would require A to make a remedial allocation of $1.52 of deductions to B for each of years 11 through 39. A must also make an offsetting remedial
allocation to OP of $1.52 of taxable income, which must be of the same type as income produced by the property.

3. Shifting Liabilities

a. Similar to the result under the traditional method, upon B’s admission and the book-up, the $60 of minimum gain is reduced to $0 and $60 of Section 704(c) minimum gain is created. Moreover, OP’s share of debt at the beginning of the first year is $60.40 (no Section 704(b) partnership minimum gain, $60 Section 704(c) minimum gain, and $.40 excess nonrecourse liabilities [$40 x .01%]). During the first year, book depreciation of $5.54 reduces the book basis to $94.46 and tax depreciation of $4 reduces the tax basis to $36. Therefore, the remaining Section 704(c) gain, and the amount of Section 704(c) minimum gain, decreases from $60 to $58.46 ($94.46 book value less $36 tax basis). Concomitantly, partnership minimum gain of $5.54 is created (the excess of nonrecourse debt of $100 over the book value of $94.46).

b. OP’s share of the debt at the end of year 1 is the sum of (i) $.06, its share of partnership minimum gain ($5.54 x .01), plus (ii) $58.46, its share of Section 704(c) minimum gain, plus (iii) $36, its share of excess nonrecourse liabilities ($36 x .01). Thus, its total share of liabilities is $58.88, a decrease of $1.52 from its share of liabilities at the beginning of the year. This amount is a deemed distribution of cash under Section 752(b). The remedial allocation of $1.48 increases basis, and there is a net reduction in basis of $.04 ($1.52-$1.48). Thus, OP’s basis is reduced from $.40 to $.36. OP’s share of liabilities will similarly be reduced by $1.52 for each of years 2 through 10, and in each of those years OP will also receive a $1.48 remedial income allocation. Thus, by the end of the tenth year, OP’s basis will be reduced to zero. At the end of the tenth year, the tax basis of the property will be reduced to zero and the book value will be $44.60 ($100 less ($5.54 x 10 yrs.)) OP’s share of the debt at the end of year 10 is the sum of (i) $.55, its share of partnership minimum gain ($55.40 x .01), plus (ii) $44.60, its share of Section 704(c) minimum gain. No portion of the debt is allocated under the third tier for excess nonrecourse liabilities. Thus, its total share of liabilities is $45.15.

c. Starting in year 11, and for the remaining depreciable life of the property, OP will experience an annual decrease of
$1.52 in its share of liabilities which will constitute a deemed distribution of cash under Section 752(b). This will be precisely offset by the $1.52 remedial allocation of income to OP, so that there is no distribution in excess of basis and basis remains at zero. OP’s share of the debt at the end of year 11 is the sum of (i) $.57, its share of partnership minimum gain ($56.94 x .01), plus (ii) $43.06, its share of Section 704(c) minimum gain. Thus, its total share of liabilities is $43.63, which represents a reduction of $1.52 from the prior year.

4. Impact on B

   a. B will receive annual tax depreciation and remedial deductions of $5.48 for each of the next ten years and an allocation of $1.52 of remedial deductions for each of years 11 through 39. In an outright sale B would only receive $2.56 of tax depreciation annually over a 39 year period.

VII. ALTERNATIVE 5: PARTNERSHIP ADMISSION WITH NO BOOK-UP TRANSACTION

A. Generally

1. The Section 704(b) regulations do not require the restatement of capital accounts upon the admission of a new partner. They do, however, admonish the taxpayer who chooses not to book up to sections of the regulations entitled “Effect of other sections” and “Other possible consequences”, thereby implying that such transactions may give rise to e.g., compensation or other income in situations where the result of not booking up is to create a shift in “unrealized” capital. See Treas. Reg. § 1.704-1(b)(2)(iv)(f).

2. As noted above, in cases where the partnership has substantial equity value, a book up (or a special allocation of gain on sale that accomplishes a similar result) will be necessary to avoid shifting economic value to the new partners. However, where the property is overleveraged and there is no equity value to shift, the determination of whether to book up or not may be driven by an analysis of the tax risks and benefits.

3. The absence of a book-up generally has the effect of shifting built-in gain or built-in loss away from the partners who were partners at the time such gain or loss accrued (in an economic rather than tax sense). This outcome runs counter to the intent behind Section 704(c) which is to prevent the shifting of tax consequences among
partners with respect to pre-contribution gain or loss. Treas. Reg. § 1.704-3(a)(1).

B. Proposed Transaction - Assume again that the principal amount due on the nonrecourse debt is $100, and that the entire principal amount is due at the end of 10 years. A’s old partners (collectively, “OP”) have a capital account in A equal to ($60). B makes a capital contribution of $1 and acquires a 99% interest in the partnership. However, the partnership elects not to “book up” OP’s capital accounts to $0 under Treas. Reg. § 1.704-1(b)(2)(iv)(f).

C. Consequences of Partnership Admission With No Book-Up

1. OP has a capital account of ($60). Because the entire built-in gain of $60 existing at the time of admission is “minimum gain”, the minimum gain chargeback rules will require that $60 of income be charged back to OP upon sale of the property or any earlier event causing a reduction in minimum gain. Treas. Reg. § 1.704-2.

2. There will be no adverse tax consequence to OP upon B’s admission to the partnership. Because partnership minimum gain will be unchanged and OP’s share will remain at $60, OP will retain a sufficient share of the liability to avoid a deemed distribution Section 752(b) in excess of basis. Treas. Reg. § 1.752-3(a)(1).

3. The remaining depreciable life of the asset will continue to be 10 years and 99% of the $4 annual depreciation deduction will be allocated to B and the remaining 1% to OP.

4. OP will defer gain until an event requiring a minimum gain chargeback, such as sale of the property or repayment of principal on the loan in a year in excess of depreciation deductions.

VIII. CONCLUSION

A. Through careful planning under the partnership tax rules, a disposition of overleveraged real estate can be structured to provide a wide array of tax outcomes for the old and new owners of the property. Compared to a taxable sale, all of these outcomes involve a deferral of gain for the old owners and an acceleration of depreciation deductions for the new owners. Thus, both the old and new owners benefit on an after-tax basis. The final choice of structure-- and therefore the timing and character of gain recognition for the old owners and the extent of acceleration of depreciation deductions for the new owners -- will be determined through negotiation of the parties. By pointing out these opportunities and guiding the parties through the negotiation, the skillful tax advisor can add enormous value to the transaction.
B. Summary of Various Tax Consequences

1. Outright Sale
   a. Seller - Year 1 Capital Gain of $60.00
   b. Buyer - Cost Basis $100; Depreciation Deduction $2.56

2. Installment Sale
   a. Seller - Year 1 Capital Gain of $59.10
   b. Buyer - Cost Basis $100; Depreciation Deduction $2.56

3. Installment Sale with Wraparound Mortgage
   a. Seller - Year 1-10 Capital Gain of $6; Interest Charge Applies
   b. Buyer - Cost Basis $100; Depreciation Deduction $2.56

4. Partnership Admission with Book-Up Using Traditional Allocation Method
   a. Seller - Year 1 Capital Gain of $5.54; Year 2-10 Capital Gain of $5.94
   b. Buyer - Year 1-10 Depreciation Deduction $4

5. Partnership Admission with Book-Up Using Curative Allocation Method
   a. Seller - Year 1-10 Ordinary Income of $5.90
   b. Buyer - Year 1-10 Depreciation Deduction $10

6. Partnership Admission with Book-Up Using Remedial Allocation Method
   a. Seller - Year 1-10 Ordinary Income of $1.48
      Year 11-39 Ordinary Income of $1.52
   b. Buyer - Year 1-10 Depreciation Deduction $5.48
      Year 11-39 Depreciation Deduction $1.52

7. Partnership Admission with No Book-Up
a. **Seller** - Year 1 No Gain

b. **Buyer** - Year 1-10 Depreciation Deduction $4