Bloomberg BNA

Tax Management
Real Estate Journal™

Vol. 28, No. 8 August 1, 2012

ARTICLES

195 **Code Section 736: A Retiring Partner Case Study Involving Flexible Payments**
by R. Zebulon Law, Esq. LL.M, CPA, and Christy L. Lewis, Esq.

206 **IRS Helps Insolvent Partners in Revenue Ruling 2012-14**
by Blake D. Rubin, Esq., Andrea M. Whiteway, Esq., and Jon G. Finkelstein, Esq.

PRACTITIONER'S INSIGHTS

213 Second Circuit Vacates Tax Court Decision Disallowing Charitable Deduction for Contribution of Façade Easement

214 Tax Court Disallows Charitable Deduction for Conservation Contribution Because of Failure to Subordinate Mortgage

216 Federal Circuit Invalidates §263A Regulation Under *Chevron*

217 IRS Rules That Shares in Money Market Fund Qualify as Cash Items for REITs

218 IRS Office of Chief Counsel Advises That Permanently Moored Riverboat Casino Must Be Depreciated as Real Property

TAX MANAGEMENT ADVISORY BOARD
REAL ESTATE

Leonard L. Silverstein, Esq., *Chairman*
Buchanan Ingersoll & Rooney PC, Washington, D.C.

Howard E. Abrams
Emory University School of Law
Atlanta, Georgia

Robert L. Bachner, Esq.
Phillips, Nizer, Benjamin, Krim & Ballon
New York, New York

Edwin H. Baker, Esq., Epstein
Becker & Green
New York, New York

Prof. Bradley T. Borden, Esq.
Brooklyn School of Law
Brooklyn, New York

Jerry L. Bowman, Esq.
Bowman Green Hampton & Kelly PLLC
Chesapeake, Virginia

Martin B. Cowan, Esq.
Attorney at Law
New York, New York

Gerald S. Deutsch, Esq.
Attorney at Law
Glen Head, New York

Joseph L. Ferst, CPA
Deloitte & Touche LLP
Atlanta, Georgia

Stephen D. Gardner, Esq.
Cooley LLP
New York, New York

Michael Hirschfeld, Esq.
Dechert
New York, New York

David Kempler, Esq.
Secretary of the Advisory Board
Buchanan Ingersoll & Rooney PC
Washington, D.C.

H. Grace Kim, Esq.
Grant Thornton LLP
Washington, D.C.

Howard Levinton, Esq.
Grant Thornton, LLP
Baltimore, Maryland

Leslie H. Loffman, Esq.
Syosset, New York

Robert E. Madden, Esq.
Blank Rome LLP
Washington, D.C.

Avram S. Metzger, Esq.
PricewaterhouseCoopers
New York, New York

Joel E. Miller, Esq.
Miller & Miller LLP
Flushing, New York

Steven F. Mount, Esq.
Squire, Sanders & Dempsey LLP
Columbus, Ohio

Frederic A. Nicholson, Esq.
Wilcox & Savage, P.C.
Norfolk, Virginia

Marshall B. Paul, Esq.
Saul Ewing
Baltimore, Maryland

Martin D. Pollack, Esq.
Weil, Gotshal & Manges, LLP
New York, New York

Donald B. Reynolds, Jr., Esq.
Secretary of the Advisory Board
Buchanan Ingersoll & Rooney PC
Washington, D.C.

Howard J. Rothman, Esq.
Kramer, Levin, Naftalis & Frankel
New York, New York

Blake D. Rubin, Esq.
McDermott Will & Emery
Washington, D.C.

Richard A. Shapack, Esq.
Shapack, McCullough & Kanter
Bloomfield Hills, Michigan

Daniel N. Shaviro, Esq.
New York University School of Law
New York, New York

Ira B. Stechel, Esq.
Wormser, Kiely, Galef & Jacobs
New York, New York

William Tatlock, Esq.
Law Office of William Tatlock
New York, New York

Stefan F. Tucker, Esq.
Venable LLP
Washington, D.C.

William P. Wasserman, Esq.
Los Angeles, California

Louis S. Weller, Esq.
Deloitte Tax LLP (Retired)
Tiburon, California

Prof. Donald T. Williamson
The American University
Kogod School of Business
Washington, D.C.

Jerry S. Williford, Esq.
Grant Thornton LLP (Retired)
Charlotte, North Carolina

Ernest G. Wilson, Esq.
McGuire, Woods, Battle & Boothe, LLP
Baltimore, Maryland

Lary S. Wolf, Esq.
Roberts & Holland, LLP
New York, New York

George E. Zeitlin, Esq.
Chadbourne & Parke
New York, New York

TAX MANAGEMENT

Gregory C. McCaffery, *President*
Darren McKewen, *Group Publisher*
George R. Farrah, CPA, *Executive Editor*
Lisa M. Pfenninger, Esq., *Editor*

BUCHANAN INGERSOLL & ROONEY PC

Donald B. Reynolds, Jr., Esq.
Elizabeth C. Minnigh, Esq.

Tax Management Real Estate Journal (ISSN 8755-0628) is published monthly, at the annual subscription rate of $807 for a single print copy, by The Bureau of National Affairs, Inc, 1801 South Bell St., Arlington, VA 22202. **Periodicals Postage Paid at** Arlington, VA and at additional mailing offices. **POSTMASTER:** Send address changes to Tax Management Real Estate Journal, Circulation Department, BNA Customer Contact Center, 3 Bethesda Metro Ctr Suite 250, Bethesda, MD 20814.

Copyright Policy: Reproduction of this publication by any means, including facsimile transmission, without the express permission of Tax Management Inc. is prohibited except as follows: 1) Subscribers who have registered with the Copyright Clearance Center and who pay the $1.00 per page per copy fee may reproduce portions of this publication, but not entire issues. The Copyright Clearance Center is located at 222 Rosewood Dr., Danvers, MA 01923. Tel. (508) 750-8400; 2) Permission to reproduce Tax Management material otherwise can be obtained by calling (703) 341-5937. Fax (703) 341-1624.

Copyright © 2012 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc., Arlington, VA 22202, U.S.A.

ARTICLES

Code Section 736: A Retiring Partner Case Study Involving Flexible Payments

by R. Zebulon Law, Esq. LL.M, CPA, and Christy L. Lewis, Esq.[1]

When a partner decides to retire or otherwise withdraw from the partnership, the retiring partner's interest is often redeemed by the partnership or purchased by the remaining partners (or a third party) in exchange for one or more payments to the retiring/withdrawing partner.[2] In many cases, there is insufficient cash for a lump-sum buyout. As a result, retirement transactions are often structured so that the retiring partner's interest is acquired in exchange for regular, fixed payments over time.

Given the recent and somewhat sustained economic downturn, partnerships (and businesses in general) are increasingly concerned about entering into agreements that require either the partnership or the remaining partners to make substantial future financial commitments. Accordingly, there has been an increased interest in structuring retirement so that payments to a retiring partner can be reduced or adjusted at some point in the future depending upon the financial condition of the parties. In general, partnerships are interested in being able to reduce payments to the retiring partner if, due to circumstances beyond the partnership's control, reduced cash flows make it necessary to reduce payments at some point in the future.

Recently, the authors worked on a retirement withdrawal transaction involving a redemption agreement with multiple liquidating distributions over a 10-year period. The case involved several aspects of §736,[3] including a variable stream of redemption distributions, and therefore required detailed drafting and planning. This article (1) reviews the two major exit strategies available upon retirement (sale or redemption) and summarize the considerations involved in deciding which strategy to implement; (2) summarizes the facts involved in the case study and applies the exit strategy analysis to the facts; (3) discusses the major tax issues involved once the parties agreed to a redemption; and (4) identifies and discusses other transactional areas of concern that apply to redemption transactions.

OVERVIEW OF RETIREMENT/ WITHDRAWAL OPTIONS

Retiring partners often have several options available when the time comes to retire or withdraw from the partnership.[4] However, if the retiring partner wishes to withdraw from the partnership altogether,[5] as opposed to retaining the partnership interest and continuing to receive a distributive share of partnership income, the withdrawal may be accomplished in one of two ways. Either the retiring partner can sell his interest to the remaining partners (or to a third party), or the partnership can redeem the retiring partner's interest. Although a retiring partner can be provided with a single lump-sum payment in exchange for his or her interest in the partnership, this article will discuss only those transactions involving multiple payments over time and will focus mainly on issues relating to redemption transactions involving liquidating distributions.

---

[1] R. Zebulon ("Zeb") Law, Esq., is a tax attorney at R. Zebulon Law, A Professional Corp., located in Costa Mesa, California. His practice is focused on tax planning, estate planning, business planning, and trust administration matters.

Christy L. Lewis, Esq., is a tax attorney at R. Zebulon Law, A Professional Corp., located in Costa Mesa, California. Her practice is focused on tax planning, estate planning, and business planning matters.

[2] Manning, 716 T.M., *Partnerships — Current and Liquidating Distributions; Death or Retirement of a Partner*, at V.

[3] Except as otherwise indicated, references in this article to "§" are to sections of the Internal Revenue Code and the Treasury Regulations promulgated thereunder.

[4] See Manning, 716 T.M., *Partnerships — Current and Liquidating Distributions; Death or Retirement of a Partner*. Several areas of the portfolio describe various transactions that could involve a retirement or withdrawal of a partner, including a dissolution of the partnership, a sale of the entire partnership, a merger of the partnership with another partnership, etc. Note that this article uses the term "retire," although the Revised Uniform Limited Partnership Act now uses the term "disassociation." *See, e.g.*, California Uniform Limited Partnership Act of 2008, §15906.01. Note the California Beverly-Killea Limited Liability Company Act, §17252 still refers to the "withdrawal" of a member from a limited liability company (as opposed to the "disassociation" of a partner in a partnership). Internal Revenue Code §736 applies to distributions made to either retiring or the successor of a deceased partner, so references to a "retiring" partner in this article also apply to payments made to the successor of a deceased partner, as applicable.

[5] This article assumes, in all cases, that the withdrawal is complete (i.e., the disassociation or withdrawal represents a complete liquidation of the applicable interest). Section 736 applies only to distributions made to a partner in complete liquidation of the partner's interest. Regs. §1.736-1(a)(1)(i).

© 2012 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

SALE TRANSACTIONS VS. REDEMPTION TRANSACTIONS

Partnership agreements and operating agreements often include provisions detailing how partner or member withdrawals (i.e., for retirement) will be accomplished. Some agreements require the remaining partners to purchase the retiring partner's interest (these provisions are sometimes referred to as "cross purchase" provisions). Other agreements require the partnership to redeem the retiring partner's interest (these provisions are sometimes referred to as "redemption" provisions). However, it is also somewhat common for partnership agreements to be silent about what occurs upon retirement, or to take a "wait and see" approach regarding the structure of future withdrawals.[6] In situations where the partnership agreement does not outline the specific structure of future withdrawals, the parties should first compare the tax consequences of a sale involving multiple promissory note payments with the tax consequences of a redemption involving multiple liquidating distributions, before making a decision regarding the structure of the withdrawal transaction.

In the case of a sale involving installment payments, the retiring partner generally recognizes gain or loss according to the installment sale rules of §453, and the partnership receives a basis adjustment equivalent to the full amount of any consideration paid to the retiring partner in exchange for his or her interest (including the promissory note).[7] In the case of a redemption involving liquidating distributions, the retiring partner recognizes gain or loss according to the terms of §736.[8] Under the "default" rule of §736, distributions to a retiring partner in exchange for his or her interest in partnership property are characterized as §736(b) payments,[9] and all excess distributions to a retiring partner are characterized as distributive shares of partnership income under §736(a)(1) or guaranteed payments under §736(a)(2).[10] Section 736(a)(2) payments are taxable as ordinary income to the retiring partner under §61(a) and are deductible by the partnership under §162(a).[11] The tax treatment of §736(a)(1) payments, however, is determined by the characterization of the income at the partnership level, and therefore may be taxable at capital gain or ordinary income rates, depending upon the source of the income to the partnership.[12]

Timing of gain or loss to a retiring partner with respect to payments made to the retiring partner in liquidation of §736(b) property is governed by §731. In general, gain is not recognized until the sum of §736(b) distributions exceed the retiring partner's basis in his or her partnership interest, and loss is not recognized until the final §736(b) distribution is made, and the total amount distributed is less than the partner's basis in his or her partnership interest.[13] As for the timing of any adjustments to the partnership's basis, the partnership does not receive basis adjustments for §736 liquidating distribution payments until the retiring partner recognizes gain under §731.[14]

ADDITIONAL CONSIDERATIONS IN REDEMPTION TRANSACTIONS

If the partnership (or operating) agreement requires a redemption transaction, or if the parties have otherwise decided to structure the withdrawal as a redemption transaction involving multiple payments over time (as opposed to a sale transaction involving installment payments), the parties still have many planning items to consider. For example, the parties should ask the following questions to help determine what type of a structure is needed: What will the overall redemption price be? How long (and how often) will distributions be made to the retiring partner? How will the liquidating distributions be allocated for income tax purposes? Will there be any "interest" paid on the distributions? Will any payments be made to the retiring partner other than §736 distributions, and if so, what are the tax consequences of such payments?

During this stage of the negotiations, counsel should enter into "fact-finding" mode in order to better understand the facts surrounding the transaction, and the goals of the parties involved. One starting place is to get a rough idea of where the parties stand with respect to what portion of the distribution will represent payments in exchange for the partner's interest in partnership property (including goodwill) under §736(b), and what portion of the payments (if any) will represent guaranteed payments or a distributive share of income under §736(a). Additionally, the retiring partner may be interested in receiving pay-

---

[6] Examples of a "wait and see" approach include provisions whereby purchase is optional (as opposed to mandatory) or, for example, where the remaining partners are entitled to a first right to purchase the retiring partner's interest, followed by the entity having the option to purchase.

[7] McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners* ¶22.17 (4th ed. 2007) (hereinafter, "McKee").

[8] §736(a) and (b).

[9] §736(b).

[10] §736(a).

[11] Regs. §1.736-1(a)(4).

[12] Regs. §1.736-1(a)(4); §702. *See, e.g.*, McKee at 22-26 and 22-27.

[13] Regs. §1.731-1(a)(2).

[14] McKee at 22-18.

© 2012 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

ments as compensation for services (also known as guaranteed payments), consulting fees, or other ongoing benefits from the partnership (i.e., health insurance, car allowance, etc.). The parties should then consider how to resolve any outstanding loans between the partner and the partnership. The parties should then consider provisions which impact their income tax planning, such as what portion of the payments (if any) will represent deferred compensation under §736(a), and what portion of the payments (if any) will represent payments in exchange for a covenant not to compete.[15] Finally, the parties should consider other transactional issues, including but not limited to indemnification provisions and the procedures that should apply in the event that the partnership is unable to satisfy the distribution obligations agreed to in the redemption agreement.

Accordingly, the following case study is based on an actual redemption agreement entered into by a retiring partner in connection with his withdrawal from the partnership. Because the agreement was drafted at the time of retirement, the parties were able to structure the agreement with enough flexibility to account for the recent economic downturn and their concerns about the future. Specifically, the parties were able to construct an agreement that allows for future payment reductions in the event that the partnership's cash flow is reduced due to certain unforeseen circumstances.

CASE STUDY — FACTUAL SUMMARY

This article will focus on the following case study, based on a recent client transaction,[16] which involved a two-member limited liability company that was taxed as a partnership. The following facts applied:

1. The company was in the financial services industry and had a fair market value of approximately $30 million.
2. The company's operating agreement did not include any provisions relating to the structure of a retirement withdrawal.
3. The retiring member wanted $15 million for his membership interest.
4. The company had been in existence for approximately 15 years, and both members were founding members (i.e., neither member had acquired his or her interest at a time when a §754 election was in place).[17]
5. The retiring member wanted to continue receiving compensation for services and benefits after retirement.[18]
6. The company agreed to redeem the retiring member's interest in exchange for payments over time (ultimately, the parties agreed that payments would be made over 10 years, with a substantial reduction occurring in the sixth year).
7. The company wanted all distributions to be made in cash (i.e., no other property was distributed to the retiring member).
8. The parties agreed to document the transaction using a redemption agreement.[19]
9. The parties wanted to equalize the tax consequences to the maximum extent possible. In other words, they wanted to structure the payments such that the tax results were as neutral as possible as to each party.
10. The company was concerned that, due to the nature of the economy and the possibility of future declines in the stock market, the company might lose revenue, and therefore was unwilling to commit to a fixed stream of payments over 10 years.[20]

---

[15] Manning, 716 T.M., *Partnerships — Current and Liquidating Distributions; Death or Retirement of a Partner*, at V,A, fn. 1419 (citing *Frontier Chevrolet Co. v. Comr.*, 116 T.C. 289 (2001), *aff'd*, 329 F.3d 1131 (9th Cir. 2002) (noncompete in connection with redemption of a shareholder's 75% interest is a §197 intangible, because in connection with acquisition of indirect interest in a trade or business)).

[16] In order to protect the anonymity of the client involved in the case study, all of the facts and amounts have been revised somewhat.

[17] *See* McKee at 22-19 through 22-23, in which the authors give an excellent set of examples highlighting the tax differences that arise when a partner is redeemed and the partner had acquired the partnership interest with and without a §754 election in place.

[18] The retiring member had previously been diagnosed with a terminal disease, so it was important for his health benefits to continue. The retiring member was willing to continue providing services to the company, although with reduced hours. (Accordingly, he was willing to accept a reduction in compensation for his services.)

[19] Counsel is strongly advised to consider carefully all of the ethical issues involved with the representation before representing the parties to such a redemption agreement. This is particularly the case in our hypothetical case study, where the payments might vary considerably, depending on future events. In general, the partnership and the retiring partner each should retain separate counsel. Even if the partnership and the retiring partner have separate counsel, the interests of each of the remaining partners may differ. Counsel should get the remaining partner(s) to agree on a comprehensive conflict waiver before representing the partnership for the redemption agreement. See Manning, 716 T.M., *Partnerships — Current and Liquidating Distributions; Death or Retirement of a Partner*, at V. Introductory Material.

[20] Money management firms in this industry receive fees based on assets under management. A decline in the overall stock market would result in reduced gross revenues for this client. Certainly, one way to handle the uncertain future cash flows would be for the parties to agree on a reduced price. In our fact pattern, however, the retiring partner held firm to his desired retirement

© 2012 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

CASE STUDY TRANSACTIONAL OUTLINE

Preliminary Considerations — Sale vs. Redemption

Applying the facts in the case study to the introductory discussion of sales vs. redemptions above (and because the company's operating agreement was silent as to what occurred upon retirement), the parties first considered the impact to each party of structuring the withdrawal as a sale. First, a sale transaction would result in capital gain (a lower tax rate) to the retiring member, which was preferable to the retiring member. Second, a sale transaction would immediately change the tax status of the company from a partnership to a disregarded entity, a result which was not preferable to the remaining member. Finally, if structured as a sale transaction, none of the liquidating payments would be deductible by the remaining member (the company), and the remaining member definitely wanted to deduct at least some of the payments. Accordingly, the parties decided to structure the withdrawal as a redemption transaction.

Redemption Transaction Details

Once the parties decided to structure the withdrawal as a redemption transaction, the parties still had to agree on the value of the retiring member's interest. The $15 million proposed value did not include discounts for lack of marketability or lack of control, and both parties wanted the liquidation to be distributed over a period of time that would result in affordable payments for the company.

The redemption price and distribution schedule were both dependent upon the company's projected cash flow. In particular, the company earned revenue based on a percentage of the client funds it managed (also known as "assets under management"). Simply put, if the company's assets under management (AUM) increased, so would its revenues; if the AUM declined, the company's revenues would also decline.[21] Accordingly, it was important for the distribution schedule to account for known risks (i.e., certain customer withdrawals that the company was already aware of), unknown risks (unforeseen risks), and risks that are more difficult to quantify (i.e., the possibility that the Dow Jones Industrial index would drop substantially at some point in the future). While the parties certainly could have agreed on a reduced purchase price of $12 million (instead of $15 million) to more accurately reflect the risks involved with such a buyout, the retiring member wanted to stay as close as possible to the $15 million figure.[22]

During this process, the retiring member and the remaining member were encouraged to focus on the amounts they would each be receiving or paying, on an after-tax basis. For example, if the entire $15 million took the form of §736(b) distributions (subject to capital gain treatment), the company would receive a basis adjustment equivalent to the gain recognized by the retiring partner (or to the extent the payment represented goodwill, the cost would be amortized over 15 years), and the retiring member would pay tax at a blended federal and state (California) capital gain tax rate of around 22%. On the other hand, if the entire $15 million took the form of §736(a) guaranteed payments, the company would receive a deduction for the full $15 million, and the retiring member would be subject to a blended income tax rate of approximately 42%.[23]

The parties understood that the redemption payments would be governed by §736. In determining the final price, they wanted the tax treatment to be as "equalized" as possible between the two members.[24] This turned out to be a complicated analysis,[25] but the parties ultimately agreed on a final redemption value of $15 million.

price. Please note that, although the case study involves a financial firm, the concern over the loss of future revenues applies to most industries. For example, a partnership holding commercial real estate might be concerned that a major tenant could vacate (reducing cash flow to the partnership) during the redemption distribution term. Similarly, a service partnership might be concerned about clients leaving the firm upon the retirement of a partner.

[21] The company received its management fees quarterly, based on the amount of assets under management on the last day of each calendar quarter.

[22] In this case, the retiring member was confident he could have received $15 million in a sale to a third party.

[23] Both blended rates take into account the deduction of California's 9.3% (presumed) tax on the federal income tax return. In certain instances, alternative minimum tax rules will reduce or negate this deduction.

[24] In this sense, the members understood that "equalized" meant the retiring partner, to the extent he received §736(b) distributions, would be taxed at a capital gains rate (as mentioned above, with a top state tax rate in California at 9.3% and a top federal capital gains tax rate of 15%, the blended rate, after the deduction for state income on the federal income tax return, was approximately 22%), while the company would not receive any deduction (other than for goodwill, which would be amortized over 15 years under §197); however, to the extent the distributions constituted §736(a) payments, the company would receive a deduction for income tax purposes, and the retiring partner would be subject to a blended federal and state ordinary income tax rate of approximately 42%. The members wanted to accomplish an overall tax rate in between the 22% and 42% figures. Note that this analysis does not take into account the benefit of the ordinary income tax deduction on the company. That benefit was intentionally disregarded as a deal point in this case.

[25] Many assumptions had to be made. Among other things, the portion of the §736(b) distributions representing goodwill would effectively be amortized over 25 years (i.e., the distribution pay-

© 2012 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

CASE STUDY — TAX ANALYSIS

Section 736 Analysis

The rules involved with fixed §736 payments to a retiring partner are well established and documented.[26] Under the final redemption agreement, the company would redeem the retiring partner's partnership interest in exchange for multiple liquidating payments over time. Therefore, §736 applied.[27] The distributions made by the company to the retiring member, to the extent they represented the member's share of company property, would be categorized as §736(b) distributions, generally subject to capital gain tax treatment. The parties worked with the company's accountants to allocate the distributions into three categories: (1) return of basis;[28] (2) §736(b)(1) distributions (generally subject to capital gains tax); and (3) §736(a) guaranteed payments, which are deductible by the company and included in the retiring partner's income as ordinary income.[29] Finally, the compensation for services payments would be taxable as ordinary income to the retiring partner and deductible by the company (in the case study, the retiring member agreed to continue performing services for the company, subject to a reduced workload, for two years after the date of the redemption agreement).[30]

As mentioned in the factual summary above, the remaining member wanted to be able to deduct at least some of the distribution payments. Accordingly, the parties agreed that $2 million of the $15 million redemption price would consist of §736(a) guaranteed payments. Although the parties discussed goodwill and analyzed its tax effects during the negotiation process, goodwill payments were not specified in the final agreement.[31]

After these preliminary discussions, the parties ultimately decided that, of the $15 million in payments to the retiring partner, $2 million would represent §736(a) guaranteed payments, $12 million would represent §736(b) payments, and $1 million would represent current compensation for services and benefits. The §736(b) distributions were targeted to be approximately $1.8 million for each of the first six years, followed by distributions of $300,000 per year for the remaining four years.[32] The $2 million in §736(a) guaranteed payments were to be made within the first two years, and all of the above distributions were to be made on a quarterly basis.[33]

The final agreement included fixed payments to the retiring member over a 10-year period. However, these payments were conditioned on the company's assets under management (AUM) remaining within a set range over the entire 10-year period. Specifically, if the company's AUM remained within 20% (plus or minus) of a particular target amount, then the distribution payments would remain fixed for the entire 10-year period (with the fixed payment schedule decreasing dramatically after year five). Alternatively, if the company's AUM declined by more than 20%, or fell below a $2 billion floor, the distribution payment would be reduced proportionately from the floor amount. For example, if the AUM declined to $1.8 billion (10% below the $2 billion floor amount), then the distribution payment that year would decline by 10%, from $1.8 billion to $1.62 billion.

---

ment to the retiring member in the tenth year would have been amortized by the company for the succeeding 15 years). Also, the parties assumed there would be no change in tax rates over the entire 25-year period.

[26] See, e.g., Manning, 716 T.M., *Partnerships — Current and Liquidating Distributions; Death or Retirement of a Partner*, at V. *See also* McKee, chapter 22; 51 *N.Y.U. Ann. Inst. on Fed. Tax'n* §8.01–8.04 (1999). Note also that §736 itself has not been amended in nearly 20 years. The last change to §736 was made in the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66), which added paragraph (3) to §736(b), effective for partners retiring or dying after Jan. 5, 1993.

[27] Regs. §1.736-1(a)(1)(i). The liquidation of the entire interest can occur over time. See Manning, 716 T.M., *Partnerships — Current and Liquidating Distributions; Death or Retirement of a Partner*, at V. As noted in the Manning portfolio, redemption transactions must carefully avoid being structured as disguised sales, and must avoid leading to situations where the partnership terminates. *Id.* This article assumes that there is no disguised sale or termination of the company.

[28] For reference purposes, in the case study, the retiring member's basis in the company's assets was $1.6 million.

[29] McKee at 22-10.

[30] The parties agreed that the retiring partner would receive compensation for services equal to $300,000 per year.

[31] Normally, distributions made for goodwill are not treated as §736(b) distributions unless the partnership agreement includes a specific allocation for the goodwill. §736(b)(2)(B). In this case, the parties had specifically referenced goodwill in the company's operating agreement, but no portion of the redemption price was allocated to goodwill. It is arguable whether the limitation in §736(b)(3) would apply. Oddly, the company made money by investing other peoples' capital (thus, arguably, capital is a material income-producing factor). However, the retiring member was not a general partner. As a result, goodwill would have been amortized for 15 years after every goodwill payment was made to the retiring member.

[32] In the case study, all payments to the retiring member were to be made in cash. Accordingly, this article does not address distributions of property (other than cash) to a retiring partner.

[33] It is noted that the portion of the redemption payment representing the $1 million guaranteed payment each year will be reported to the retiring partner on line 4 (guaranteed payments) of Schedule K-1 each year. The guaranteed payment will not impact the retiring partner's capital account (reported on item L of Part II of Schedule K-1). The $1.8 million of §736(b) payments would be reported as a "distribution" on line 19 (distributions) of the partner's Schedule K-1.

© 2012 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

CASE STUDY — UNIQUE ISSUES INVOLVED WITH VARIABLE DISTRIBUTIONS

The possibility that distributions could vary raises several tax and transactional issues. In many cases, these issues overlap. The balance of this article identifies such issues and discusses how each issue was handled in the case study.

"Catch-Up" Provision

The retiring member had two questions: First, what happens if the AUM falls below $2 billion, and then subsequently rises above $2 billion? Second, what happens if the company's AUM rises above $2.5 billion? Before these questions were raised, the redemption agreement had simply measured the company's AUM as of the last day of each quarter (for the first six years), and adjusted the $1.8 million payment ($450,000 on a quarterly basis) only if the AUM fell outside of the target range. If the AUM fell back into the target range, the redemption agreement simply brought the distribution (for that quarter) back to the scheduled payment of $450,000. In other words, the agreement did not include a "catch-up" provision.

For example, if the company's AUM dropped to $1.8 billion in the first quarter of Year 2, the parties agreed that the distribution for that quarter would drop by 10% (from $450,000 to $405,000). If the AUM increased back to $2 billion in the following quarter, the distribution would simply adjust back to the scheduled $450,000 (with no reimbursement of the previous reduction amount).

However, the parties certainly could have included a catch-up provision allowing for underpayments to be recaptured in a future quarter in the event that certain financial goals were achieved. In other words, distributions would be subject to an increase only to the extent of any previous distribution reduction. For example, if AUM increased to $2.2 billion after a previous quarter in which AUM had decreased to $1.8 billion, then a catch-up distribution of $45,000 could be made in the subsequent ($2.2 billion) quarter.

Allocating the Reduction in Liquidating Distributions for Income Tax Purposes

Given the possibility that payments would be reduced at some point in the future, the parties needed to determine and agree on the tax consequences of such a reduction. For example, the parties needed to determine whether such a reduction would reduce the amount allocated to §736(a) payments or the amount allocated to §736(b) payments. Ultimately, the parties agreed that the entire reduction would be allocated to §736(b) payments.[34]

Measuring the Retiring Partner's Gain or Loss

The retiring member needed to consider how to report the gain or loss associated with liquidating his membership interest. The retiring member's basis in his membership interest was $1.6 million. Under Regs. §1.731-1(a), the retiring member generally does not recognize gain until the amount of money he receives exceeds his basis.[35] Under an exception to the general rule, the retiring partner recognizes income to the extent that the distribution payment represents a guaranteed payment or a distributive share of partnership income under §736(a). Because $800,000 of the retiring partner's initial $1.8 million distribution represented the retiring partner's share of unrealized re-

---

[34] As a technical matter, if the parties had decided that any portion of the reduction would be applied to the §736(b) component, they would have to further agree as to how the reduction would be allocated to a *specific part* of §736(b). For example, they had to agree whether any reduction in liquidating distributions would represent a reduction allocated against amounts paid for unrealized receivables or goodwill. In the case study, there was no goodwill. However, in other cases, goodwill is amortized by the buyer over 15 years, so consideration should be given as to whether any reduction in payments would be applied against goodwill. Similarly, any allocation made against unrealized receivables would reduce the deduction taken by the company (and would also reduce ordinary income to the retiring partner). Again, in our case study, the parties agreed any reduction would be made to the "normal" §736(b) distributions, not related to either goodwill or unrealized receivables.

[35] As noted in McKee, the recognition of gain by the retiring member highlights a crucial tax difference between a sale and redemption of a retiring partner's interest. The transaction would likely be considered a contingent installment sale. §453(d); see Starczewski, 565 T.M., *Installment Sales*. A detailed analysis of the tax treatment is beyond the scope of this article, but roughly, the terms of the redemption agreement will be analyzed to determine whether the agreement comes under one of three sets of rules: (1) a redemption agreement with a maximum (determinable) redemption amount; (2) a redemption agreement without a maximum (determinable) redemption amount, but for which the period of payments can be determined; and (3) a redemption agreement without a maximum price and without a fixed period. *Id.* In the case study, the payments were potentially fixed, with a fixed date, but were subject to the contingency of the company's assets under management staying within a certain range.

Separately, it should be noted that, in the current tax environment (as of the date this article is being submitted, capital gains tax rates are set to substantially increase as of Jan. 1, 2013), the retiring member might receive an unintended "negative" tax consequence, in that his basis will be recovered in 2011 and 2012 (in which capital gains tax rates are low), and he will start recognizing gain in 2013 (when rates are scheduled to go higher). Counsel considering similar transactions should consider the possibility of tax rates changing and include appropriate allocations in the agreement.

© 2012 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

ceivables, the retiring member would recognize $800,000 of ordinary income on the initial $1.8 million distribution and would not recognize any gain on the remaining $1 million.[36]

The final redemption agreement also included a provision whereby the parties could mutually agree, at any time, to fix the distributions for the remainder of the distribution term (removing the variable payment option). Such a provision can be used to provide the parties with peace of mind that no future distributions will be adjusted.[37] However, it is unclear how such a provision would be governed under Regs. §1.736-1(b)(5). For example, the regulations do not provide any guidance about whether payments (while they are potentially variable) can be reported under the cost recovery method of Regs. §1.736-1(b)(5)(ii) and then subsequently reported on a pro-rata method under Regs. §1.736-1(b)(5)(i) after the payment schedule is fixed (modified).

The Effect of §754 on Basis

As payments are made to a retiring member, the company can receive basis adjustments for the portion of distributions representing §736(b) payments, as long as one of the following applies. First, a partnership can receive a basis adjustment if a §754 election is in place.[38] Second, a partnership can receive a basis adjustment to the extent that gain is recognized by the retiring partner under §751(b) (relating to unrealized receivables).[39] In the event that one of these two conditions applies, the partnership will receive a basis adjustment in the same year and to the same extent that the retiring partner recognizes gain with respect thereto.[40]

As applied to the case study, a §754 election was in place, and the retiring member realized $800,000 of income for §736(a) unrealized receivables during the first year (out of $1.8 million). Accordingly, the company would receive an $800,000 step-up in the basis of its receivables; however, it will receive no other basis adjustments until the retiring member recognizes gain on the remaining §736(b) distributions. Even when the retiring member does recognize gain, the company does not receive any further basis adjustments unless a §754 election is in place.

The variable payment option raises another question relating to how the partnership's basis should be adjusted. If Regs. §1-736-1(b)(5)(ii) is closely followed, the retiring member will not recognize gain (other than gain related to the receipt of §751 property) until the distributions to the retiring member exceed his or her basis in the partnership assets. Accordingly, the retiring partner will recognize gain with respect to every distribution thereafter. Additionally, if the company has a §754 election in place, the company's basis in the assets will need to be adjusted (to the extent of the gain recognized by the retiring partner) every year thereafter. Accordingly, counsel should certainly factor in the potential costs involved with making such an adjustment every year.

Distribution Increases

In the case study, the retiring member agreed to accept reduced §736(b) distributions under certain financial circumstances, but only if the distributions were also capable of increasing in the event that certain financial conditions were met. In essence, the retiring partner wanted to include an "earn-out" or a bonus if the company achieved certain financial goals.[41] The parties ultimately agreed that distributions could increase in the event that the company's AUM exceeded $2.5 billion.[42]

The possibility of these increased distributions raises two important tax questions. First, how is the increase allocated for income tax purposes? Second, is the allocation any different if previous distributions have been reduced?

---

[36] Regs. §1.736-1(b)(5)(i) provides that, in the case of fixed payments, distribution will be allocated for income tax purposes in a ratio by which the §736(b) portion bears to the sum of the §736(a) and §736(b) payments. Although not free from doubt, the case study involved payments which were likely not fixed in amount. As such, the reporting would normally be governed under Regs. §1.736-1(b)(5)(ii), which provides for a cost recovery (return of basis) rule of reporting. However, in our specific case, the parties identified on a schedule attached to the agreement how they wanted the distribution payments allocated, so the rule of Regs. §1.736-1(b)(5)(iii) applied — the allocation may be (and was) specified in a manner agreed upon by the parties.

[37] One particular consideration was a concern that successors-in-interest to the retiring member or to the company might not interpret the distribution payment schedule properly, so the parties wanted "back door" protection to be able to lock up future distribution amounts.

[38] §734.

[39] McKee at 22-12.

[40] McKee at 22-12; §§736(b)(2)(A), 751(b), 734.

[41] In essence, the retiring member argued that if he were bearing the financial "risk" of the company's assets under management decreasing below a certain amount, he should bear the financial reward if the company's assets under management rose above certain thresholds. Normally, such an "earn-out" provision would be used to pay a bonus to owners selling a business to a third party; the earn-out bonus is paid when the selling owners continue to help the business (usually for a year or two after the date of sale, under a consulting agreement); the selling owners receive incentive to make sure the sale of the business transitions smoothly and effectively. Earn-out provisions are unusual in the context of a retiring partner.

[42] Increases in distributions to the retiring member could be made only in the first six years of distributions.

© 2012 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

Distribution increases are allocated in the manner prescribed by §736.[43] Any distribution representing an amount that exceeds the reasonable value of partnership property is allocated to §736(a).[44] Because the distribution increases in the case study are based on an increase in the company's profits, they would exceed the value of the partnership interest and would be equivalent to receiving a distributive share of the company's income (not a guaranteed payment).[45] Accordingly, the amount of any such increase would be taxable as a §736(a)(1) payment.

The tax allocation process becomes more complicated when the purpose of an increased distribution is to "make up" for previous underpayments. For example, under Regs. §1-736-1(b)(5)(i), if an underpayment is made in one year, and an overpayment is made in a subsequent year, the overpayment may be allocated to §736(b) to the extent that such overpayment "makes up" for the unpaid, yet previously agreed upon value, of the §736(b) assets of the partnership; and only the amounts in excess of the agreed upon value will be allocated to §736(a). Although the case study did not involve fixed payments, the parties still agreed to allocate any increase to the retiring member to §736(b) until the retiring member was "made whole" and for any excess (over the scheduled and agreed upon amount) to be allocated to §736(a).[46]

Reporting/Compliance

Section 736(a) guaranteed payments are reported to the retiring partner on line four (4) of Schedule K-1. Section 736(b) distributions are reported to the retiring partner on line nineteen (19) of Schedule K-1. It should also be noted that during the liquidating distribution period, the retiring partner will continue to receive a K-1 from the partnership, irrespective of the fact that the partner is no longer a partner for state law purposes.

Because the retiring member continues to receive a K-1 from the company, several planning and drafting concerns arise. First, the retiring member will continue to receive basis adjustments with respect to the company's debts until a final distribution is made.[47] Second, the retiring member's basis will continue to adjust as §736(b) distributions are made (until the retiring member's basis reaches zero). Because the case study involved only one remaining member, the parties were concerned about providing the retiring partner with notice in the event of any substantial changes to the company, such as adding new members (for example, other, key employees of the company) or termination of the entity's partnership status.[48]

Benefits

It is often the case that a retiring member wishes to continue receiving benefits from the company after retiring. In the case study, the retiring member wanted his medical benefits to continue and he wanted to continue using his company vehicle. Accordingly, the parties agreed that such benefits would continue and would be reported in the manner in which they were reported before the retirement date.[49]

CASE STUDY — OTHER TRANSACTIONAL ISSUES

In structuring the variable stream of distribution payments to a retiring member, several legal questions arise, including:

1. How will the indemnification provisions be structured? For example, what happens if the retiring member is sued for company actions occurring after the retirement date? What are the tax consequences of indemnification payments? What happens if the company is sued after the retirement date as a result of actions taken by the retiring member before retirement and can the company "offset" the resulting costs against future payments to the retiring partner?
2. What happens if the company fails to make a required distribution?
3. Should the agreement include non-compete provisions? If so, how should the cost be allocated?
4. Can the partnership "prepay" any of the retiring partner's distributions?
5. What happens if the retiring member dies during the payment term?

[43] Regs. §1.736-1(b)(4).

[44] Regs. §1.736-1(b)(5)(ii).

[45] Manning, 716 T.M., *Partnerships — Current and Liquidating Distributions; Death or Retirement of a Partner*, at V.C.1; Regs. §1.736-1(b)(1).

[46] *See* Regs. §1.736-1(b)(5)(iii).

[47] McKee at 22-14.

[48] Ultimately, the parties included a covenant in the redemption agreement that the company would notify the retiring partner of any "substantial change," such as a merger of the company or termination of the entity's status.

[49] Each retirement will have different circumstances involving benefits. On occasion, a retiring partner may wish to make continued payments to the partnership's retirement plan (or to start receiving distributions from a nonqualified pension plan). The parties can agree to extend these benefits for a limited amount of time or for the entire term of the redemption payments. Generally, benefits are taxed in accordance with normal, benefit rules for the duration of time in which the retiring partner receives distributions.

© 2012 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

This following discussion will address each of these issues.

Indemnification/Offset Provisions

When a retiring partner withdraws from the partnership (or when a member leaves a limited liability company), the redemption (or sale) agreement often includes provisions regarding the details (timing and conditions) of indemnification. In most cases, the retiring partner is asked to indemnify the partnership against claims resulting from the partner's actions and the partnership is asked to indemnify the retiring partner for claims resulting from actions taken by the partnership after the date of retirement.

In the case study, the parties agreed to include indemnification provisions in the redemption agreement. Specifically, the company agreed to indemnify the retiring member for claims arising as a result of the company's actions after the date of retirement and the retiring member agreed to indemnify the company for claims arising as a result of the retiring member's gross negligence and/or willful misconduct.

These indemnification provisions, however, were subject to the following limitations. First, all indemnification claims needed to be brought within 18 months of the date of retirement. Second, all indemnification claims could be brought only if they exceeded a "basket" amount of $100,000. Last, the retiring member's liability for indemnification was limited to $12 million (the §736(b) component of the total purchase price). Conceptually, the retiring member did not want the amount of his potential indemnification liability to exceed the amount of his potential liability during the time in which he was employed by the company.

The parties in the case study agreed to include an offset provision for the purpose of offsetting or reducing distribution payments by any amounts paid to third parties as a result of the retiring member's actions. For example, if the company were to pay $3 million as the result of a claim brought against the company (due to the gross negligence or willful misconduct of the retiring member), the company would be entitled to offset or reduce the retiring member's balance of distribution payments by $3 million.

Related to the offset provisions is the issue of how to allocate the offset for tax purposes. Because the indemnification would principally apply during the first 18 months after retirement (when the retiring member was receiving substantial guaranteed payments),[50] the parties could have agreed to allocate a substantial portion of any offset to the §736(a) guaranteed payment component of the redemption. However, the indemnification payments were structured to make the company "whole"; therefore, the company would actually be receiving distributions whether or not they were previously allocated to §736(a) or §736(b).

In the end, the parties agreed that any indemnification amount would impact the §736(b) distributions and would not affect any §736(a) guaranteed payments.[51]

Default Provisions

The retiring member wanted to structure the redemption agreement with some sort of provision that would provide an assurance, or guarantee[52] that he (and his successors in interest) would receive all future distributions. First, the parties discussed the option of having the remaining member sign a personal guaranty for the distributions. However, due to the inherent nature of §736 distributions (in this case study, a portion of which represented guaranteed payments as well as distributive share), it was unclear whether a guaranty would be enforceable under state law.[53] Second, the parties discussed the option of having the retiring partner file a UCC-1 against the assets of the company to create a public record regarding the obligation. Ultimately, the retiring partner chose not to require any security, other than the contractual obligation of the redemption agreement.

The parties also discussed the option of including provisions that would prevent (or restrict) the com-

[50] Recall that the retiring member would be receiving $1 million in guaranteed payment, and $1.8 million in §736(b) distributions. In the first year, $800,000 of the §736(b) distributions was allocated to unrealized receivables. If a major indemnification event had occurred in the first year, each of these might have arguably been impacted.

[51] This allocation is likely justified under Regs. §1.736-1(b)(5)(iii). However, theoretically, an indemnification in favor of the company represents the company being "made whole." A better allocation would probably have been to simply reverse the allocations previously made to the retiring member. For example, if a $2.8 million indemnification had occurred right after the first year, $1 million would be allocated to §736(a) and $1.8 million allocated to §736(b).

[52] By way of clarification, the term "guarantee" (having a third-party surety assure that a payment is made under state law if the primary obligor does not make the payment) should not be confused with the term "guaranteed payment" in §736 — for tax purposes, it simply means the payment is made whether or not the partnership has profit.

[53] As is pointed out in McKee, the liquidation distribution obligation is not a "liability" that is booked for accounting or tax purposes. McKee at 22-17. Two other tax issues not addressed in the case study could have arisen in connection with the guarantee. First, if the remaining member had guaranteed the distribution, and then had to perform under the guarantee, the company would probably have been insolvent, and forced to terminate under its license agreements (to trade securities). Second, the redemption structure virtually changes to a sale structure once the remaining member starts making direct payments to the retiring member.

© 2012 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

pany from taking actions that might artificially lower the redemption price. For example, the company agreed not to make substantial revisions to its policy of receiving fees based on assets under management without the consent of the retiring member.[54] The parties also included a provision whereby the company agreed it would not take certain actions without the consent of the retiring partner.[55]

In general, the parties to a redemption agreement can include provisions that allow a retiring partner (or member) to take back his or her partnership interest in the event that the partnership defaults on its payment obligations under the redemption agreement. However, if such provisions are included, the parties will need to consider whether the retiring partner is entitled to take back *all* of his interest (the total amount of liquidating distributions under the redemption agreement), or if the retiring partner is limited to taking back only the unpaid portion of his interest. For example, if a retiring partner (holding 33.33% of the partnership) is entitled to $8 million in redemption payments and the partnership defaults after the partner receives $4 million of redemption payments. The parties will have to determine whether the retiring partner would be entitled to take back all of his or her original 33.33% interest, or whether he or she would only be entitled to receive 16.66% of his or her original interest (with the other 16.66% deemed already paid by the partnership). In the case study, the parties agreed that the retiring member would be entitled to take back only the portion of his interest that represented the remaining unpaid balance of his original interest.

Noncompete Provisions

Normally, when a partner retires from a service partnership, the partnership will ask the partner to enter into some form of covenant not to compete. Furthermore, it is not uncommon to tie the enforcement of the covenant not to compete with the cessation of payments in the event that the retiring partner "defaults" by engaging in competitive activity that is prohibited under the agreement.

In the case study, the retiring member agreed not to compete and the parties agreed that the company would be required to notify the retiring member if the company believed the retiring member was engaged in a competitive activity, and to give the retiring member 30 days to cure the action.[56] If the retiring member did not cure the action, then the company would be entitled to discontinue all further payments to the retiring member.[57]

It should be noted that under state law, a retired partner who receives liquidating distributions pursuant to a redemption agreement is no longer considered a partner and therefore does not have an ongoing fiduciary duty not to compete in the absence of such provisions in the redemption agreement.[58]

Prepayments

In the case study, because the parties had negotiated provisions allowing for flexible distributions to the retiring member, they considered whether the company would have the ability to prepay one or more scheduled distributions to the retiring member. They included two provisions in the redemption agreement addressing prepayment.

The first provision was analogous to a "due on sale" provision which would normally be found in a promissory note. Under this provision, if the company was sold during the 10-year distribution term, the retiring member would be entitled to the full amount of all remaining distribution payments. Under the second provision, the company could simply elect, at any time, to pay the retiring partner all the remaining distributions in full.[59] For income tax purposes, the parties agreed to follow the allocations set forth in the redemption agreement, so that only the timing of the tax reporting would be impacted (i.e., accelerated) by a prepayment.

Death During Term

Due to the health of the retiring member, the parties in the case study carefully considered what would occur if the retiring partner died during the 10-year distribution period. The parties agreed that the §736(b) payments for interest in partnership property

[54] Other cases might include §736 distributions based on profit of the company; in such instance, provisions limiting the partnership's expenses may be appropriate.

[55] The covenants would be similar to the covenants a bank and lender might require in making a loan to a business. For example, one covenant was that the company would not pay any excessive compensation for services to the remaining member, or make excessive distributions to the remaining member, without the consent of the retiring member, during the first six years of the liquidation term.

[56] Due to the poor health of the retiring member, and because the retiring member would be working (with reduced hours) for the company, the parties considered it unlikely that he would enter into any competitive activity.

[57] If distributions had stopped, presumably some kind of loss would have been recognized by the retiring member. The parties did not address this issue in the case study.

[58] This would be the case even if the retired partner continues receiving a K-1 from the partnership.

[59] In both cases, the parties specified that the prepayment would be for *scheduled* distributions, not hypothetical distributions that might have been adjusted due to market conditions, etc.

© 2012 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

and the §736(a) guaranteed payments would continue to be paid to the retiring member's successor-in-interest upon his death. As for the payments representing compensation for services and benefits, the parties agreed that such payments would discontinue upon the death of the retiring partner.

Although the agreement clearly sets forth the allocation and resulting tax treatment of the liquidating distributions, the question remains as to how the potentially adjustable stream of distributions will be valued for estate tax purposes. It is likely that an appraiser would value the interest based on the possibility that future payments may be reduced. Although the retiring member in the case study was married and his redemption interest was held in a living trust, valuing the stream of redemption payments is still important insofar as the appraised value will impact the determination of which property ought to be allocated to the bypass trust (and because they lived in California, a community property state, the valuation is also important for purposes of measuring the step-up in basis that occurs at the first death).[60] Informal discussions with appraisers have indicated that normal valuation methods apply, in addition to using a so-called "Monte Carlo" simulation (which randomizes possible outcomes) in order to take into account the uncertainty involved with the variable stream of distribution payments.

The retiring partner's partnership interest will receive a step-up in basis equivalent to the fair market value of the interest on his or her date of death.[61] If, as in our case study, a §754 election has been made, future §736(b) distributions will be subject to capital gain only to the extent that such payments exceed the transferee's new adjusted (and stepped up) basis in the partnership interest.[62] However, to the extent that §736(a) guaranteed payments continue after the retired member's death, such payments will constitute income in respect of a decedent (IRD),[63] and no basis adjustment will apply to that particular component.[64]

CONCLUSION

Earlier this year, while this article was being written, the retiring member passed away after a 15-year battle with cancer. His death occurred less than nine months from the effective date of the redemption agreement described in the case study. Due to current economic conditions, the §736 distributions already have been reduced in accordance with the formula set forth in the redemption agreement. The distributions are being paid to the member's successor-in-interest, and the authors are currently working with the retired member's estate to determine the value of the distribution payments for estate tax purposes among other issues related to the death of the retiring partner.

Although the case study involved a very particular set of facts that many practitioners may not typically encounter, it is hoped that the concepts, transaction points, and tax issues discussed in this article will assist other practitioners in similar situations involving the retirement or withdrawal of a partner (or member).

---

[60] §1014(a) (as to the decedent spouse's community interest), (b)(7) (as to the surviving spouse's community interest).

[61] §§1014(a), (b), 742; Regs. §§1.1014-1(a), (b), 1.742-1; Manning, 716 T.M., *Partnerships — Current and Liquidating Distributions; Death or Retirement of a Partner*, at V,D.

[62] See Manning, 716 T.M., *Partnerships — Current and Liquidating Distributions; Death or Retirement of a Partner*, at V,D,1 and V,D,4.

[63] §691(a)(1); Regs. §§1.691(a)-1(b), 1.691(a)-2. Manning, 716 T.M., *Partnerships — Current and Liquidating Distributions; Death or Retirement of a Partner*, at V,D,4.

[64] §1014(c).

© 2012 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

IRS Helps Insolvent Partners in Revenue Ruling 2012-14

by Blake D. Rubin, Esq.,
Andrea M. Whiteway,Esq.,
and Jon G. Finkelstein, Esq.[1]
McDermott Will & Emery LLP
Washington, D.C.

On May 25, 2012, the Internal Revenue Service (the "IRS") issued Rev. Rul. 2012-14,[2] which provides guidance regarding the application of the insolvency exclusion to the recognition of cancellation of indebtedness ("COD") income under §108(a)(1)(B) as it applies to partners in a partnership. Specifically, Rev. Rul. 2012-14 provides that, for purposes of measuring a partner's insolvency under §108(d)(3), each partner treats as a liability an amount of the partnership's discharged nonrecourse debt in excess of the value of the property securing such debt in proportion to such partner's allocation of the resulting COD income to such partner under §704(b), and not based on the partner's allocable share of the excess nonrecourse debt under the §752 regulations. We applaud the IRS for adopting a taxpayer-favorable approach to the application of the insolvency exclusion to discharged partnership excess nonrecourse debt. In our view, the IRS's approach reaches the correct economic result and is consistent with the "fresh start" policy behind the insolvency exclusion.

COD INCOME, THE INSOLVENCY EXCEPTION AND REVENUE RULING 92-53

Generally, a debtor must recognize income upon a cancellation of indebtedness.[3] However, §108(a)(1)(B) provides in relevant part that gross income does not include any amount that would otherwise be includible in gross income as COD income if the discharge occurs when the taxpayer is insolvent. To the extent §108(a)(1)(B) applies, the amount of COD income excluded from gross income is limited to the amount by which the taxpayer is insolvent. §108(a)(3). For purposes of the insolvency exclusion, the term "insolvent" means the excess of liabilities over the fair market value of assets of the taxpayer, as determined immediately before the discharge. §108(d)(3). Section 108(d)(6) provides that, in the case of a partnership, the relevant taxpayer for purposes of applying the insolvency exclusion is the partner and not the partnership.[4] Accordingly, if a partnership realizes COD income, the extent to which the insolvency exclusion to recognition of the COD income will apply is made at the partner level.

To the extent a taxpayer's COD income is excluded under §108(a)(1)(b), §108(b)(1) provides that the amount excluded must be applied to reduce the tax attributes of the taxpayer as provided in §108(b)(2). Absent an election under §108(b)(5) to first reduce the basis of depreciable property, §108(b)(2) and the regulations thereunder[5] provide that the tax attributes of a taxpayer are reduced in the following order: (i) net operating losses; (ii) general business credits under §38; (iii) minimum tax credits under §53(b); (iv) capital loss carryovers under §1212; (v) basis of property; (vi) passive activity losses and credit carryovers under §469(b); and (vii) foreign tax credit carryovers.[6] Section 108(b)(2)(E) provides that the basis of property is reduced under the rules described in §1017.[7]

In Rev. Rul. 92-53,[8] the IRS addressed whether nonrecourse debt is taken into account in determining whether a taxpayer is insolvent for purposes of §108(a)(1)(B). Because a lender's right to pursue a borrower under a nonrecourse loan is limited to the fair market value of the assets securing the nonrecourse debt, the issue arises as to whether the full principal balance of the nonrecourse debt should be taken into account in the insolvency determination. The IRS noted that the legislative history of the insolvency exclusion indicates that the purpose of the exclusion is to preserve a taxpayer's "fresh start" resulting from the discharge of debt by ensuring that the

[1] Copyright 2012 Blake D. Rubin, Andrea M. Whiteway and Jon G. Finkelstein. All rights reserved.

[2] 2012-24 I.R.B. 1012.

[3] §61(a)(12); *Kirby Lumber Corp. v. U.S.*, 284 U.S. 1 (1931).

[4] In the case of a partner that is an entity disregarded as separate from its owner for federal income tax purposes, Prop. Regs. §1.108-9 provides that the owner of the disregarded entity is the relevant taxpayer for purposes of applying the insolvency exclusion.

[5] Regs. §1.108-7(a)(1).

[6] In general, the reduction of tax attributes described in §108(b)(2) is one dollar for each dollar of COD income excluded under §108(a). §108(b)(3)(A). However, reduction of credits described in §108(b)(2) is 33⅓ cents for each dollar of excluded COD income. §108(b)(3)(B).

[7] Section 108(d)(6) provides that the attribute reduction rules of §108(b) are applied at the partner, and not the partnership, level.

[8] 1992-2 C.B. 48.

© 2012 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

taxpayer will not be burdened with tax on the related COD income.[9]

Consistent with the purpose of the exclusion, the IRS determined that the amount by which a nonrecourse debt exceeds the fair market value of the property securing the debt (the "excess nonrecourse debt") should be treated as a liability in determining insolvency, but only to the extent that the excess nonrecourse debt is discharged. However, the IRS further determined that, to the extent the excess nonrecourse debt is not discharged, the nonrecourse debt should be taken into account in determining a taxpayer's insolvency only to the extent of the fair market value of the property securing the debt. The IRS stated that "excess nonrecourse debt that is not discharged does not have a similar effect on a taxpayer's ability to pay tax resulting from the discharge of another debt (whether recourse or nonrecourse). Thus, that excess nonrecourse debt should not be treated as a liability in determining insolvency for purposes of Section 108 of the Code."

Example 1. Rev. Rul. 92-53 analyzed the application of the insolvency exclusion with respect to excess nonrecourse debt in three situations. In situation 1, an individual taxpayer borrowed $1 million from a second individual (the lender) on a nonrecourse basis that was secured by an office building valued at more than $1 million. When the value of the building declined to $800,000 and the outstanding principal balance of the note was $1 million, the lender agreed to reduce the principal balance of the note to $825,000. At that time, the taxpayer's only other assets had an aggregate fair market value of $100,000 and the taxpayer was personally liable to a fourth individual on other indebtedness of $50,000. Under the IRS's application of the insolvency exclusion to excess nonrecourse debt as set forth in Rev. Rul. 92-53, $175,000 of the taxpayer's $200,000 excess nonrecourse debt is discharged and is taken into account in determining whether the taxpayer is insolvent. The taxpayer has liabilities of $1,025,000, consisting of the $50,000 of recourse debt plus the portion of the nonrecourse debt equal to the sum of the $800,000 fair market value of the property securing the nonrecourse debt and the $175,000 of excess nonrecourse debt that is discharged. Because the $1,025,000 of liabilities exceeds the $900,000 of fair market value of his assets by $125,000, he is insolvent to the extent of $125,000 and the taxpayer excludes $125,000 of the $175,000 of COD income under §108(a)(1)(B).

Before Rev. Rul. 2012-14 was issued, it was not clear how to apply Rev. Rul. 92-53 to a partnership's excess nonrecourse debt. As noted above, the determination of whether the insolvency exclusion applies with respect to the discharge of a partnership liability must be made at the partner level. Accordingly, if excess nonrecourse debt of a partnership is discharged in a transaction giving rise to COD income, each partner must determine the share of the excess nonrecourse debt such partner can include for purposes of applying the insolvency exclusion. It was not clear whether, for this purpose, a partner's share of the excess nonrecourse debt should be determined under the liability allocation rules contained in §752 or, alternatively, whether the partner's share of the excess nonrecourse debt for this purpose should be based on the partner's allocable share of the related COD income under §704(b). A partner's allocable share of a partnership's nonrecourse liability may not be in the same proportion as the allocation of the COD income to such partner under §704(b).[10] Indeed, in Rev. Rul. 92-97,[11] the IRS specifically confirmed that an allocation of COD income that differs from the allocation of the underlying partnership debt can be respected under the §704(b) regulations.

Example 2. Assume partnership PRS has two partners, A and B. PRS borrows $1 million from Bank on a nonrecourse basis secured by assets with a value in excess of $1 million. Neither A nor B are personally liable for the partnership's nonrecourse debt. The nonrecourse debt is allocated 90% to A and 10% to B under Regs. §1.752-3(a)(3) in accordance with the manner in which nonrecourse deductions attributable to the nonrecourse debt are expected to be allocated to A and B. However, income is generally allocated equally to A and B under the partnership agreement. In Year 2, when the value of the assets securing the $1 million nonrecourse debt falls to $800,000, the lender agrees to reduce the debt to $825,000. Because the partnership has $200,000 of excess nonrecourse debt, the $175,000 discharge of debt is entirely attributable to an excess nonrecourse liability. Under the partnership agreement, each of A and B are allocated $87,500 of COD income. If a partner's share of a discharged excess nonrecourse debt for purposes of the insolvency exclusion is determined based on a partner's allocable share of the COD income under the

---

[9] *See* H.R. Rep. No. 833, 96th Cong., 2d Sess. 7, 9 (1980); S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 10 (1980).

[10] For a comprehensive discussion of the §752 regulations, see Blake D. Rubin, Andrea M. Whiteway and Jon G. Finkelstein, "Creative Planning to Control Partnership Liability Allocations," 62 *N.Y.U. Federal Tax Institute Chapter* 8 (2004).

[11] 1992-2 C.B. 124.

© 2012 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

§704(b) regulations, then each of A and B can take into account $87,500 of the excess nonrecourse debt as a liability in determining the application of the insolvency exclusion.

However, if a partner's share of a discharged excess nonrecourse debt is determined based on a partner's allocable share of the discharged nonrecourse debt under the §752 regulations, then A can take into account $157,500 of the excess nonrecourse debt for purposes of determining A's insolvency, while B can take into account only $17,500 of the debt for purposes of determining B's insolvency. As noted above, the stated purpose of the insolvency exclusion is to give a taxpayer a "fresh start." Subjecting a taxpayer to tax on COD income that the taxpayer would not be able to pay is inconsistent with that purpose. As shown in Example 2, treating a partner as having a share of excess nonrecourse debt in accordance with the partner's §752 share of the debt may have no relationship to the tax liability that the partner will bear as a result of the partnership debt discharge and may result in a tax liability in excess of what the taxpayer is able to bear. We believe it is arguably more consistent with the purpose of the insolvency exclusion to treat a partner as having a share of discharged partnership excess nonrecourse debt in proportion to the partner's allocable share of the partnership's COD income under the §704(b) regulations. It is certainly more favorable to taxpayers.

REVENUE RULING 2012-14

Consistent with the analysis described above, in Rev. Rul. 2012-14, the IRS determined that, for purposes of determining whether a partner is insolvent under §108(a)(1)(B), the partner treats as a liability an amount of the partnership's discharged excess nonrecourse debt that is based on the allocation of the COD income to the partner under the §704(b) regulations.

Example 3. In Rev. Rul. 2012-14, X and Holdco, a corporation, are equal partners in partnership PRS. In Year 1, PRS borrows $1 million from Bank on a nonrecourse basis that is secured by real estate valued in excess of $1 million. The ruling states that the note is a nonrecourse liability within the meaning of Regs. §1.752-1(a)(2) and neither PRS nor its partners are personally liable on the note. In Year 2, when the value of the real estate has fallen to $800,000 and the outstanding principal amount of the note is still $1 million, Bank agrees to reduce the principal amount of the note to $825,000. The example assumes that, at the time that the Bank reduces the note's principal amount, PRS has no partnership minimum gain with respect to the note under Regs. §1.704-2(d)(1) and that the modified note bears adequate stated interest within the meaning of §1274(c)(2). The PRS partnership agreement provides that income is allocated equally to X and Holdco and that X and Holdco share PRS nonrecourse liabilities equally under Regs. §1.752-3. At the time of the modification of the note, X and Holdco have no assets or liabilities other than their partnership interests in PRS, PRS's sole asset is the real estate subject to the note, and PRS's sole liability is the note.

The IRS noted that, in order to properly apply Rev. Rul. 92-53 in a partnership context, the partnership's discharged excess nonrecourse debt should be associated with the partner who, in the absence of the insolvency or other §108 exclusion, would be required to pay the tax liability arising from the discharge of that debt. In this case, the $175,000 of COD income resulting from the modification of the note is allocated equally between X and Holdco under §704(b) and the regulations thereunder. Because each of X and Holdco would be required to pay the tax liability with respect to $87,500 of the discharged excess nonrecourse debt, the IRS states that each of X and Holdco should be treated as having an $87,500 liability for purposes of the insolvency determination under §108(a)(1)(B). In this case, X and Holdco have no assets or liabilities other than their partnership interests in PRS and the value of such partnership interests are $0 (i.e., the $800,000 value of the property owned by PRS is subject to an $825,000 nonrecourse liability, of which only $800,000 is taken into account). Each of X's and Holdco's liabilities therefore exceed the value of their assets by $87,500 and each of X and Holdco are insolvent. Accordingly, X and Holdco each exclude their $87,500 of COD income under §108(a)(1)(B).

Although the facts in Rev. Rul. 2012-14 do not raise the issue of an inconsistency between the allocation of the discharged excess nonrecourse debt under §752 and the allocation of the COD income under the §704(b) regulations, the ruling clearly addresses the issue described above in Example 2 so that A and B in that example would be treated as having an allocable share of the discharged excess nonrecourse debt in proportion to their allocable share of COD income. We applaud the IRS for applying Rev. Rul. 92-53 in a taxpayer favorable manner in the partnership context. The IRS's application of Rev. Rul. 92-53 to a partnership's discharged excess nonrecourse debt makes economic sense and is consistent with the purpose of the

© 2012 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

insolvency exclusion described in the legislative history to §108.

Section 752 Nonrecourse vs. Section 752 Recourse

The facts of Rev. Rul. 2012-14 specify that the excess nonrecourse debt at issue is a nonrecourse liability under the §752 regulations. In contrast, Rev. Rul. 92-53 applies to state law nonrecourse liabilities (i.e., a liability for which a creditor's only recourse is specified collateral). We note that the state law characterization of a liability as recourse or nonrecourse does not determine whether a liability is recourse or nonrecourse for §752 purposes.[12] A partnership liability is a recourse liability for purposes of §752 to the extent that any partner or related person bears the "economic risk of loss" for that liability without reference to how the liability is characterized for state law purposes.[13] In general, recourse liabilities are allocated to the partner who would be responsible for paying them if the partnership were unable to. In order to determine who bears the economic risk of loss for a recourse liability, the regulations employ a "constructive liquidation" test. Regs. §1.752-2(b)(1) provides that upon a constructive liquidation, all of the following events are deemed to occur simultaneously:

- All of the partnership's liabilities become payable in full;
- With the exception of property contributed to secure a partnership liability, all of the partnership's assets, including cash, have a value of zero;
- The partnership disposes of all of its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditor's right to repayment is limited solely to one or more assets of the partnership);
- All items of income, gain, loss, or deduction are allocated among the partners; and
- The partnership liquidates.

A partner bears the economic risk of loss for a liability to the extent that if the partnership constructively liquidated, the partner (or a related person) would be obligated to either pay a creditor or make a contribution to the partnership because the liability would be due and the partner (or related person) would not be entitled to reimbursement.[14] A partnership liability is a nonrecourse liability for purposes of §752 to the extent that no partner or related person bears the economic risk of loss for that liability.[15]

Accordingly, although a liability of a partnership may be a nonrecourse liability for state law purposes because the lender's remedies against the partnership in the event of a default are limited to specified collateral owned by the partnership, the liability may nevertheless be characterized as a recourse liability for purposes of §752.[16] For example, a partner may have guaranteed the liability so that, under the constructive liquidation analysis described above, such partner would bear the economic risk of loss for the liability. Similarly, a liability that is recourse from a state law perspective may constitute a nonrecourse liability for purposes of §752 because no partner bears the economic risk of loss with respect to the liability. For example, a state law recourse debt of a limited liability company would fall into this category because the members of the limited liability company would be protected from personal liability.

Rev. Rul. 2012-14 presumably applies only to partnership debt that is nonrecourse for purposes of §752. Accordingly, Rev. Rul. 2012-14 does not address how discharged §752 recourse debt should be taken into account for purposes of the insolvency exclusion.

Unlike excess nonrecourse debt, which can be taken into account for purposes of determining a taxpayer's insolvency only to the extent discharged, a partner's allocable share of a §752 recourse liability

[12] For a thorough discussion of the characterization of debt as recourse or nonrecourse for purposes of §§1001, 752 and 704(b), see Blake D. Rubin, Andrea M. Whiteway and Jon. G. Finkelstein, "Treatment of Liabilities as Recourse or Nonrecourse in a Complex Financial World," 13 *Journal of Passthrough Entities* No. 4 (2010).

[13] Regs. §1.752-1(a)(1).

[14] Regs. §1.752-2(b).

[15] Regs. §1.752-1(a)(2).

[16] The §704(b) regulations clearly contemplate that a liability characterized as nonrecourse under state law and for purposes of §1001 may nevertheless be characterized as a recourse liability for purposes of §752. *See* Regs. §1.704-2(b)(4) (" 'Partner nonrecourse debt' or 'partner nonrecourse liability' means any partnership liability to the extent the liability is nonrecourse for purposes of §1.1001-2, and a partner or related person (within the meaning of §1.752-4(b)) bears the economic risk of loss under §1.752-2 because, for example, the partner or related person is the creditor or a guarantor").

© 2012 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

of a partnership arguably should be taken into account in full for purposes of the insolvency determination and arguably should increase the partner's insolvency to the extent the recourse obligation exceeds the value of the partner's assets. To the extent the value of the partnership's assets are insufficient to satisfy the §752 recourse liability, such partner's liabilities with respect to the partnership interest would exceed the value of the partnership interest. As a result, the partner's interest in the partnership arguably should be taken into account as a net liability in the partner's insolvency determination.

We note that this approach may be inconsistent with *Merkel v. Comr.*,[17] where the Tax Court held that a taxpayer's guarantee of a corporation's note should generally not be treated as a liability in determining the taxpayer's insolvency and the taxpayer's qualification for the insolvency exclusion. In *Merkel*, the Tax Court concluded that in order for a guarantee of a corporation's liability to be treated as a liability under the insolvency exclusion, it must be more probable than not that a taxpayer will be called upon to pay the guarantee.[18] Although the *Merkel* court's treatment of a guarantee may be inconsistent with our suggested approach for the treatment of partnership §752 recourse liabilities, arguably partnership liabilities should be treated differently from corporate liabilities for purposes of the insolvency exception. Indeed, partnership liabilities are clearly distinguishable from corporate liabilities for many purposes under the Code. For example, partnership liabilities are taken into account in determining a partner's tax basis in a partnership while corporate liabilities are not taken into account in determining the basis of a shareholder's interest in a corporation. Further guidance on the extent to which a §752 recourse liability can be taken into account for purposes of the insolvency exclusion would be helpful.

Another issue raised by Rev. Rul. 2012-14 is how to determine whether a debt discharge is attributable to excess nonrecourse debt when a debt is partially recourse and partially nonrecourse under the §752 regulations.

Example 4. Assume the same facts as in Example 2, except that $200,000 of PRS's $1 million of nonrecourse debt is guaranteed by A pursuant to a "bottom" guarantee[19] so that A bears the economic risk of loss with respect to $200,000 of the debt and A's guarantee remains outstanding after $175,000 of the debt is discharged. Is the $175,000 debt discharge attributable to the $800,000 of §752 nonrecourse debt, so that Rev. Rul. 2012-14 clearly applies, or is it attributable to the $200,000 of §752 recourse debt? Given that A's guarantee remains outstanding so that A would continue to bear the economic risk of loss with respect to $200,000 of the $875,000 of the partnership's debt, we believe that the discharge should be treated as a discharge of §752 nonrecourse debt and Rev. Rul. 2012-14 would apply.[20]

Partnership Liabilities under §1017

As noted above, to the extent a partner is determined to be insolvent and excludes COD income under §108(a)(1)(B), the partner is required to reduce certain tax attributes in accordance with §108(b). To the extent the partner is required to reduce the partner's tax basis in assets, §1017(b)(2) provides that the reduction in basis shall not exceed the aggregate of the basis of the property held by the partner immediately after the debt discharge, over the *aggregate of the liabilities* of the taxpayer immediately after the discharge. Section 1017, however, does not define the term "liabilities," and the term is not defined elsewhere in the Code or in Treasury regulations. Although Rev. Rul. 2012-14 is helpful in determining whether a partner can take into account excess partnership nonrecourse debt in determining the partner's insolvency under §108(a)(1)(B), there is currently no guidance regarding whether a partner's allocable share of partnership liabilities under the §752 regulations is taken into account as a liability of the partner for purposes of the basis reduction rules under §1017(b)(2). We believe that a partner's share of a partnership liability under the §752 regulations should constitute a liability for purposes of calculating the

[17] 109 T.C. 463 (1997), *aff'd*, 192 F.3d 844 (9th Cir. 1999).

[18] *Id.* at 484.

[19] A "bottom guarantee" is a guarantee of the last dollars of the debt, which is the least risky portion of the debt. For example, if the total nonrecourse debt is $100 and the Contributing Partner guarantees $40 pursuant to a bottom guarantee, the Contributing Partner will only be liable to pay on its guarantee in the event that the property securing the debt declines in value to less than $40.

[20] *See* Regs. §1.752-1(i) ("If one or more partners bears the economic risk of loss as to part, but not all, of a partnership liability represented by a single contractual obligation, that liability is treated as two or more separate liabilities for purposes of section 752. The portion of the liability as to which one or more partners bear the economic risk of loss is a recourse liability and the remainder of the liability, if any, is a nonrecourse liability"). See also Regs. §1.704-2(d)(2)(ii) and Regs. §1.704-2(m), *Ex. 1 (vii)*, which make it clear that, for purposes of computing partnership minimum gain with respect to a liability, the portion of a nonrecourse liability that is secured by a "bottom guarantee" should be treated as a liability of a higher priority than the portion of the nonrecourse liability that is not guaranteed so that an amount of the partnership's basis in the assets securing the liability would first be attributable to the guaranteed portion of the liability.

© 2012 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

limitation on basis reduction under §1017(b)(2). As noted above, the stated purpose of excluding COD income under §108 for certain taxpayers, including those that are insolvent, is to provide such taxpayers with a "fresh start" so that the taxpayer is not immediately burdened with a tax liability related to the discharged debt. With respect to the liability floor to the basis reduction under §1017, Congress stated:

> [A]ny remaining debt discharge amount is applied to reduce asset basis, but not below the amount of the taxpayer's remaining undischarged liabilities. (Thus a sale of all the taxpayer's assets immediately after the discharge generally will not result in income tax liability unless the sale proceeds and cash on hand exceed the amount needed to pay off the remaining liabilities.)[21]

Thus, the liability floor prevents the discharge of debt from giving rise to excessive future taxable gain to an insolvent debtor, and ensures that the debtor is able to repay its post-insolvency debts.[22] The legislative history makes clear that Congress's intent in enacting the insolvency exclusion and the attribute reduction rules, along with the basis reduction limitation under §1017(b)(2), was to ensure that a debtor should not only avoid immediate tax liability with respect to indebtedness discharged, but should also be afforded an additional fresh start by limiting its future recognition of income (arising from attribute reduction) to amounts that the debtor would be able to pay after discharging its remaining liabilities using its remaining assets. Thus, in the absence of a specific definition or direct authority, we believe that the term "liability" should be interpreted in a manner that carries out the "fresh start" policy and Congress's intent to limit a debtor's immediate post-discharge tax liability.

Moreover, §752(d) provides that upon a sale or exchange of a partnership interest, "liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships." The rules under §1001 provide that "the amount realized from the sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition."[23] The §1001 regulations further provide that "liabilities from which a [partner] is discharged as a result of the sale or disposition of a partnership interest include the [partner's] share of the liabilities of the partnership."[24] Thus, under §§752(d) and 1001, a partner's allocable share of a partnership liability must be included as an "amount realized" upon a sale or exchange of the partnership interest. As illustrated by the following example, the fresh start policy and the purposes of §1017(b)(2) would be violated if a partner's allocable share of a Regs. §1.752-1 liability is not treated as a liability under §1017(b)(2).

Example 5. Assume that a debtor realizes COD income of $2,000 and that the taxpayer is insolvent for purposes of §108(a)(1)(B). Following the debt discharge, the debtor has no attributes other than basis in property, the debtor's sole asset is a partnership interest with a net fair market value of $100 and a basis of $1,500, and the debtor's sole liability is an allocable share of the partnership's liabilities of $1,400, which the debtor has guaranteed. If the debtor's allocable share of the partnership liability is not taken into account for purposes of §1017(b)(2), the debtor would be required under §108(b)(2) to reduce the basis of its assets to zero. Assume the debtor shortly thereafter sells the partnership interest for $100 of cash. Under §§752(d) and 1001, the debtor would have an amount realized of $1,500 (the $100 sale price plus the $1,400 of the debtor's allocable share of the Regs. §1.752-1 liability) and would recognize $1,500 of gain. The debtor would be unable to pay the resulting tax ($525, if the applicable tax rate is 35 percent). Thus, with the $1,500 of gain recognition and a tax liability of $525, the result of the example violates Congress's intent in enacting the changes to §§108 and 1017 to preserve

---

[21] S. Rep. No. 1035, 96th Cong., 2d Sess. (1980), p. 13 (emphasis added); *see also* H.R. Rep. No. 833, 96th Cong., 2d Sess. (1980), pp. 10–11 (containing substantially identical language).

[22] S. Rep. No. 1035, 96th Cong., 2d Sess. (1980), p. 13; H.R. Rep. No. 833, 96th Cong., 2d Sess. (1980), pp. 10–11. *See also* David F. Levy and Matthew J. Hofheimer, "Bankrupt Partnerships and Disregarded Entities," 127 *Tax Notes* 1103, 1105–06 (7/7/10) at 1113 ("Congress adopted the liability floor to prevent the attribute reduction process from giving rise to taxable gain, which might prevent a taxpayer from repaying its post-bankruptcy debts.").

[23] Regs. §1.1001-2(a)(1). Section 1001(a) provides that gain or loss from the sale or other disposition of property is the difference between the amount realized and the adjusted basis of the property. Section 1001(b) provides that the amount realized from a sale or other disposition of property includes the sum of money plus the fair market value of property received. The rules under §1001 have been interpreted and applied in two Supreme Court cases with respect to whether a liability is included as an "amount realized." *See Crane v. Comr.*, 331 U.S. 1 (1947) (holding that a taxpayer who sells property encumbered by a nonrecourse debt that is less than the fair market value of the property sold must include the amount of the debt as an amount realized); *Comr. v. Tufts*, 461 U.S. 300 (1983) (holding that that upon the transfer of property subject to nonrecourse debt that exceeds the fair market value of the property, the taxpayer realized gain from the sale or exchange equal to the difference between the amount of the debt and the taxpayer's basis in the property).

[24] Regs. §1.1001-2(a)(4)(v).

© 2012 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

the debtor's "fresh start."[25] In order to effectuate the clearly expressed Congressional intent regarding the effect of the §1017(b)(2) limitation, the share of partnership liabilities must be taken into account for purposes of §1017(b)(2) in order to limit the basis reduction to the $100 excess of basis over share of partnership liabilities.

[25] S. Rep. No. 1035, 96th Cong., 2d Sess. (1980), p. 10; H.R. Rep. No. 833, 96th Cong., 2d Sess. (1980), p. 9.

CONCLUSION

In Rev. Rul. 2012-14, the IRS adopted a logical and taxpayer favorable approach to the treatment of partnership excess nonrecourse debt for purposes of determining a partner's insolvency under §108(a)(1)(B). Although there are still some unanswered questions regarding the treatment of partnership debt in connection with the insolvency exclusion, we applaud the IRS on taking a significant step forward to help economically distressed taxpayers.

© 2012 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

PRACTITIONER'S INSIGHTS

Second Circuit Vacates Tax Court Decision Disallowing Charitable Deduction for Contribution of Façade Easement

As a general rule, a taxpayer may not take a deduction for the contribution of a partial interest in property.[1] However, there is an exception for "a qualified conservation contribution," which is a contribution of a "qualified real property interest" to a "qualified organization" that is made "exclusively for conservation purposes."[2] One conservation purpose, "the preservation of a historically important land area or a certified historic structure,"[3] encompasses façade conservation easements.[4] In order to deduct the value of a donated façade conservation easement, a taxpayer must obtain a "qualified appraisal" of the partial interest donated.[5] As part of the qualified appraisal, the appraiser must disclose (i) the method of valuation used to determine the fair market value, such as the income approach, the market-data approach, or the replacement-cost-less-depreciation approach,[6] and (ii) the specific basis for the valuation, such as specific comparable sales or statistical sampling, including a justification for using sampling and an explanation of the sampling procedure employed.[7]

In *Scheidelman v. Comr.*,[8] the Second Circuit overturned a Tax Court ruling that the appraisal Taxpayer had obtained insufficiently explained the method and basis of valuation and thereby failed to comply with the qualified appraisal rules under Regs. §1.170A-13(c)(3). The Second Circuit also overturned a Tax Court ruling that a mandatory cash payment by Taxpayer to a façade easement grantee was not a "contribution or gift" because Taxpayer did not sustain her burden of proving either that the payment was not made as a quid pro or, if she did receive something of substantial value, the payment exceeded the value of the benefits received. Accordingly, the Second Circuit vacated the Tax Court's decision and remanded the case for further consideration of the value consistent with its opinion.

[1] §170(f)(3)(A).

[2] §170(f)(3)(B)(iii), (h)(1); *see also* Regs. §1.170A-14(a).

[3] §170(h)(4)(A)(iv).

[4] *See Simmons v. Comr.*, 98 T.C.M. 211 (2009).

[5] §170(f)(11)(C); Regs. §1.170A-13(c)(2)(i)(A).

[6] Regs. §1.170A-13(c)(3)(ii)(J).

[7] Regs. §1.170A-13(c)(3)(ii)(K).

[8] No. 10-3587 (2d Cir. 6/15/12).

In 2003, the National Architectural Trust (NTA), an exempt organization under §501(c)(3) of the Internal Revenue Code (the "Code"), accepted Taxpayer's application to donate a façade conservation easement on the row house. NTA also required a cash donation of 10% of the easement's value. The two banks that held mortgages on the row house executed lender agreements for the donation. The National Park Service determined that the row house contributed to the significance of the historic district and was a "certified historic structure."

In 2004, Taxpayer hired Michael Drazner, a qualified real estate appraiser recommended by NTA to value the easement. Drazner estimated the unencumbered value of Taxpayer's property at $1,015,000. The report valued the façade easement at $115,000, approximately 11.33% of the total value, based in part on the range of easement values the IRS had found acceptable in the past. Taxpayer sent NTA a check for the required cash payment of $9,275, which was 10% of the value of the easement less certain adjustments. NTA confirmed receipt in a letter stating that Taxpayer had received no goods or services in return for her gifts, and a Form 8283, *Noncash Charitable Contributions*, signed by Drazner and NTA, reflecting a fair market value for the easement of $115,000.

Taxpayer claimed a $115,000 deduction on her federal tax return for the 2004 tax year, and carried over $63,083 to future years ($59,959 in 2005 and $3,124 in 2006). On audit, the IRS determined that she failed to establish a fair market value for the easement. Accordingly, the IRS notified her of resulting deficiencies in her taxes of $16,873, $17,537, and $1,015 for the years 2004 through 2006, respectively, and imposed a statutory penalty of $3,374.60, $3,507.40, and $203.00 for each year, respectively.

Taxpayer sought a redetermination of her tax liability from the Tax Court. The Tax Court held that Taxpayer was ineligible for the deduction because the Drazner appraisal was not a "qualified appraisal," as it failed to state the method of valuation and the basis of valuation.[9] The Tax Court also rejected Taxpayer's deduction of her cash contribution to the NTA. Noting that "a charitable gift or contribution must be a payment made for detached and disinterested motives,"[10] the Tax Court reasoned that Taxpayer had made the donation for the purpose of inducing NTA to accept her easement so that she could enjoy a tax benefit.

The Second Circuit, however, held that the Drazner appraisal was a qualified appraisal. The Second Cir-

[9] *Scheidelman v. Comr.*, T.C. Memo 2010-151.

[10] *Graham v. Comr.*, 822 F.2d 844, 848 (9th Cir. 1987), *aff'd sub nom. Hernandez v. Comr.*, 490 U.S. 680, 109 S. Ct. 2136, 104 L.Ed.2d 766 (1989).

© 2012 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

cuit noted that the before-and-after method used by Drazner was an accepted means of valuing conservation easements, generally used if no substantial record of marketplace data is available.[11] The Second Circuit concluded that the appraiser, Drazner, had explained at some length how he arrived at his numbers. The Second Circuit stated that, for the purpose of gauging compliance with the reporting requirement, it was irrelevant that the IRS believed the method employed was inaccurate or haphazardly applied, as long as a method was described. The Second Circuit also stated that the regulation required only that the appraiser identify the valuation method "used" to enable the IRS to evaluate it, not that the method adopted be reliable.

Moreover, the Second Circuit concluded that Drazner sufficiently supplied the bases for the valuation, namely "IRS publications (since removed from circulation), tax court decisions, Drazner's past valuation experience, and the location of the house in the regulatory environment of New York City." The Second Circuit noted that this approach was nearly identical to that approved by the Tax Court in *Simmons v. Comr.*[12] However, the Second Circuit noted that the existence of a qualified appraisal did not itself entitle Taxpayer to a deduction and, therefore, remanded the case for a determination of whether Taxpayer complied with other statutory and regulatory requirements, including that the contribution be exclusively for conservation purposes, as required by §170(h)(1)(C) of the Code, and that it be protected into perpetuity as required by Regs. §1.170A-14(a).[13]

The Second Circuit then turned to whether the $9,275 contribution to the Trust was "charitable," and, therefore, deductible under §170 of the Code. The Second Circuit noted that, while the donation might be described as a prerequisite of the Trust's acceptance of the easement donation, the Trust gave the taxpayer no "goods or services," or "benefit," or anything of value in return for her making the money gift. The Second Circuit further explained that a donee's agreement to accept a gift does not transfer anything of value to the donor, even though the donor may desire to have the gift accepted and may expect to derive benefit from the deductibility of the gift on her income taxes. Moreover, the Second Circuit noted that if the motivation to receive a tax benefit deprived a gift of its charitable nature under §170 of the Code, virtually no charitable gifts would be deductible.[14] Accordingly, citing *Kaufman v. Comr.*,[15] the Second Circuit held that a mandatory cash contribution was deductible.

This case is a significant setback for the IRS, which has been successful in several courts in disallowing a deduction for façade easements on the basis of deficient appraisals.

[11] Regs. §1.170A-14(h)(3)(i); *see also Comr. v. Simmons*, 646 F.3d 6, 11–12 (D.C. Cir. 2011) (affirming Tax Court decision holding that a before-and-after façade conservation easement valuation was a qualified appraisal); *Nicoladis v. Comr.*, 55 T.C.M. 624 (1988) ("the 'before and after approach' is the most feasible method of valuing [a façade easement] donation."); *Hilborn v. Comr.*, 85 T.C. 677, 688 (1985) (observing that the before-and-after approach is approved by Congress and the IRS); S. Rep. No. 96–1007, at 14–15 (1980) ("[B]ecause markets generally are not well established for easements or similar restrictions, conservation easements are typically (but not necessarily) valued indirectly as the difference between the fair market value of the property involved before and after the grant of the easement.").

[12] 98 T.C.M. 211 (2009), *aff'd*, 646 F.3d 6 (D.C. Cir. 2011).

[13] *See also* Regs. §1.170A-14(g)(6).

[14] *See Mount Mercy Assocs. v. Comr.*, T.C. Memo 1994-83 (1994).

[15] 136 T.C. 294 (2011) ("Seeing no benefit to [the taxpayer] other than facilitation of her contribution of the façade easement, and an increased charitable contribution deduction, we shall not deny petitioners' deduction of the cash payments on the ground that the application required a "donor endowment" to accompany the contribution of façade easement.").

Tax Court Disallows Charitable Deduction for Conservation Contribution Because of Failure to Subordinate Mortgage

Under §170(a)(1) of the Internal Revenue Code (the "Code"), a taxpayer is generally allowed a deduction for any charitable contribution made during the taxable year. However, a taxpayer is generally not allowed a charitable contribution deduction for a gift of property consisting of less than an entire interest in that property, unless it falls within certain exceptions, including a "qualified conservation contribution."[1] A "qualified conservation contribution" is a contribution of a "qualified real property interest" to a "qualified organization" that is made "exclusively for conservation purposes."[2] A contribution is made exclusively for conservation purposes only if "the conservation purpose is protected in perpetuity."[3]

With respect to property subject to a mortgage, Regs. §1.170A-14(g)(2) provides that no deduction will be permitted "unless the mortgagee subordinates its rights in the property to the right of the . . . [donee] organization to enforce the conservation purposes of the gift in perpetuity." However, a deduction will not be disallowed merely because on the date of the gift there is the possibility that the interest will be de-

[1] §170(f)(3)(A), (B)(iii).

[2] §170(h)(1); *see also* Regs. §1.170A-14(a).

[3] §170(h)(5)(A).

© 2012 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

feated, so long as on that date the possibility of defeat is so remote as to be negligible.[4]

In *Mitchell v. Comr.*,[5] the Tax Court held that a taxpayer was not entitled to a charitable deduction for the donation of a conservation easement over land she owned subject to a mortgage, on the ground that the contribution failed the "exclusively for conservation purposes" requirement because the mortgagee's deed of trust was not subordinated to the conservation easement deed until after the donation.

In 2000, Taxpayer and her husband (who died in 2006) purchased 351 acres of undeveloped land. The purchase was seller-financed. After a down payment, Taxpayer executed a promissory note for the remaining payments secured by a deed of trust on the unimproved land. In 2002, Taxpayer and her husband formed a family limited partnership (FLP) to which they transferred the land, subject to the deed of trust. On December 31, 2003, the partnership contributed a conservation easement over 180 acres to a land conservancy, which was a qualified charitable organization. On its 2003 tax return, the partnership claimed a $504,000 charitable contribution deduction, which flowed equally to its two partners, Taxpayer and her husband. At the time that the conservation easement was granted, the deed of trust securing the debt to the seller was not subordinated to the easement and, in fact, Taxpayer failed to have the mortgagee subordinate the deed of trust to the conservation easement deed until December 22, 2005. From 2003 through 2005, the partnership had the money to pay off the promissory note at any time, and all payments were made in a timely manner. The IRS issued a notice of deficiency to the taxpayer in 2010, disallowing the 2003 charitable contribution deduction on the ground that Taxpayer did not satisfy the subordination requirements of Regs. §1.170A-14(g)(2).

The Tax Court first analyzed whether Taxpayer obtaining a subordination agreement in 2005 satisfied the subordination requirement. Taxpayer argued that it was irrelevant that the subordination agreement was signed almost two years after the grant of the conservation easement because the regulation contains no requirement as to when the mortgagee must subordinate its claim to that of the donee organization. The Tax Court concluded that, while the subordination regulation is silent as to when a taxpayer must subordinate a preexisting mortgage on donated property, the regulation requires that a subordination be in place at the time of the gift in order to meet all the requirements of §170(h) of the Code and the underlying regulations at that time. Moreover, the Tax Court noted that if Taxpayer had defaulted on the promissory note before the date of actual subordination, the seller could have instituted foreclosure proceedings and eliminated the conservation easement and, therefore, the conservation easement was not protected in perpetuity at the time of the gift. Accordingly, the Tax Court held that Taxpayer failed to meet the requirements of §170(h) of the Code and the regulations thereunder for 2003.

The Tax Court then turned to the question of whether, notwithstanding the fact that the deed of trust took priority over the conservation easement until December 22, 2005, the easement was protected in perpetuity because the probability of Taxpayer's defaulting on December 31, 2003 on her promissory note was so remote as to be negligible. Taxpayer asserted that the subordination regulation must be read in conjunction with the so-remote-as-to-be-negligible standard. The Tax Court noted that, while it had previously decided that the so-remote-as-to-be-negligible standard in Regs. §1.170A-14(g)(3) should not be applied when determining whether a taxpayer has met the requirements of other subsections of Regs. §1.170A-14(g),[6] it was a matter of first impression whether the so-remote-as-to-be-negligible standard must be considered in determining whether the taxpayer satisfied the subordination requirements of Regs. §1.170A-14(g)(2).

The Tax Court also acknowledged, however, that the D.C. Circuit applied the so-remote-as-to-be-negligible standard to find that a gift of a facade easement was protected in perpetuity.[7] However, the Tax Court distinguished the D.C. Circuit case because, there, the standard was used to defeat a general argument made by the IRS as to the conservation easement's grant in perpetuity and not to defeat a specific subparagraph of Regs. §1.170A-14(g). Given the Tax Court's prior rulings under the other subsections, the Tax Court held that the subordination regulation should not be read in tandem with the so-remote-as-to-be-negligible standard.

Finally, Taxpayer argued that she and her husband had an oral agreement with the seller that they would not subdivide or develop the property. Taxpayer claimed that, because these were the same rights relinquished under the conservation easement, the oral agreement protected the conservation easement's purpose in perpetuity as required by §170(h)(5) of the Code. However, the Tax Court concluded that the oral agreement had no effect on the seller's ability to foreclose the property and extinguish the conservation

---

[4] Regs. §1.170A-14(g)(2).

[5] 138 T.C. No. 16 (2012).

[6] *See Kaufman v. Comr.*, 136 T.C. 294 (2011); *Carpenter v. Comr.*, T.C. Memo 2012-1.

[7] *See Simmons v. Comr.*, 107 AFTR 2d 2011-2632 (6th Cir. 2011), *aff'g* T.C. Memo 2009-238.

© 2012 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

easement if Taxpayer had defaulted on the promissory note. Therefore, the Tax Court held that the oral agreement also failed to comply with the requirements of Regs. §1.170A-14(g)(2). Accordingly, the Tax Court disallowed the charitable deduction.

Federal Circuit Invalidates §263A Regulation Under *Chevron*

As a general rule, §263A of the Internal Revenue Code (the "Code") requires capitalization of, instead of permitting a deduction for, certain costs incurred in improving real property. Deductions are taken in the current tax year, whereas expenses that are a capitalization must be depreciated over time. Interest is a cost requiring capitalization when that cost is "allocable" to the property.[1] To determine which costs are "allocable" to the property, §263A(f)(2) of the Code provides that interest is allocable "to the extent that the taxpayer's interest costs could have been reduced if production expenditures . . . had not been incurred." In determining the amount of interest required to be capitalized, interest on any other indebtedness is assigned to real property to the extent that the taxpayer's interest costs could have been reduced if production expenditures had not been incurred.[2] This provision is generally referred to as the "avoided-cost rule."

Production expenditures subject to capitalization include not only the amount spent on the improvement, but also the adjusted basis of the entire unit being improved that is temporarily withdrawn from service (so-called "associated property").[3] By including the adjusted basis amount, the regulation increases the amount of interest to be capitalized. In *Dominion Resources, Inc. v. U.S.*,[4] the Federal Circuit invalidated Regs. §1.263A-11(e)(1)(ii)(B), which provides special rules for the allocation of interest to property produced by a taxpayer. Invoking *Chevron v. NRDC*,[5] the Federal Circuit held that the regulation as it applied to property "temporarily withdrawn from service" was not a reasonable interpretation of §263A of the Code. Further, the Federal Circuit concluded that the Treasury Department failed to comply with the Administrative Procedure Act, which requires a reasoned explanation when regulations are promulgated.

Taxpayer provided electric power and natural gas to individuals and businesses. In 1996, it replaced coal burners in two of its plants. While making those improvements, Taxpayer temporarily removed the coal burners from service — one unit for two months, the other for three months. During this period, Taxpayer incurred interest on debt unrelated to the improvements. On its corporate tax returns, Taxpayer deducted some of that interest from its taxable income. The IRS disagreed with Taxpayer's treatment of the interest. Instead, the IRS argued that, under Regs. §1.263A-11(e)(1)(ii)(B), the interest should be capitalized not deducted. Under a settlement, the IRS allowed Taxpayer to deduct 50% and capitalize 50% of the disputed amount. Thereafter, still asserting that the entire disputed amount was deductible, Taxpayer filed this suit seeking to invalidate Regs. §1.263A-11(e)(1)(ii)(B) as it applied to property "temporarily withdrawn from service" and requesting a refund of $297,699 in corporate income tax.

The validity of a Treasury regulation is analyzed under the *Chevron* two-step test.[6] Step one requires a determination of whether Congress has directly spoken to the precise question at issue.[7] If the statute is silent or ambiguous, then step two requires a determination of whether the agency's interpretation is based on a permissible construction of the statute.[8] Under *Chevron* step one, the Federal Circuit reviewed the language of §263A(f)(2) of the Code and concluded that it was ambiguous, describing it as "opaque" and "circular." Accordingly, the Federal Circuit turned to *Chevron* step two.

Under step two, the Federal Circuit concluded that the regulation directly contradicted the avoided-cost rule that Congress intended the statute to implement.[9] The Federal Circuit reasoned that adjusted basis does not represent such an "avoided" amount because a property owner does not expend funds in an amount equal to the adjusted basis when making the improvement. Moreover, the Federal Court noted that the statute uses the term production "expenditures," the plain meaning of which is an amount actually expended or spent on the improvement. The Federal Circuit reasoned that the only way that an amount equal to the adjusted basis could potentially satisfy the avoided-cost method is by assuming that the property owner would have sold the unit and used the sale proceeds to pay down the debt. However, the Federal Circuit stated that there was no reasonable explanation for the assumption that a property owner would have sold the same unit that it removed from service for the sole purpose of improving it, since selling the unit obviates

[1] §263A(f)(1).

[2] §263A(f)(2).

[3] Regs. §1.263A-11(e)(1).

[4] 97 Fed. Cl. 239 (Fed. Cir. 2012).

[5] 467 U.S. 837, 842–43 (1984).

[6] *See Mayo Found. for Med. Educ. and Research v. U.S.*, 131 S. Ct. 704, 711–13 (2011).

[7] *Chevron*, 467 U.S. at 842–43.

[8] *Id.*

[9] S. Rep. No. 99-313, at 140, 144 (1986); H.R. Rep. No. 99-426, at 625, 628 (1985); Joint Comm. on Tax'n, JCS-10-87, 1987 WL 1364655 (1987).

© 2012 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

the very reason for the improvement. Accordingly, the Federal Court concluded that the regulation unreasonably linked the interest capitalized when making an improvement to the adjusted basis.

Accordingly, the Federal Circuit held that the associated-property rule in Regs. §1.263A-11(e)(1)(ii)(B), as applied to property temporarily withdrawn from service, was not a reasonable interpretation of §263A(f)(2)(A)(ii) because it contradicted the avoided-cost rule that the law implemented. Therefore, the Federal Circuit held that the regulation was invalid.

The Federal Circuit also concluded that the associated-property rule violated §706(2) of the Administrative Procedure Act because it failed to satisfy the requirement under *Motor Vehicles Mfrs. Ass'n of the U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, that Treasury "articulate a satisfactory explanation" for adopting a regulation, "including a rational connection between the facts found and the choice made."[10] The Federal Circuit noted that the notice of proposed rulemaking[11] provided no rationale for including the adjusted basis in the calculation other than the general statement that the regulations are intended to implement the avoided-cost method, and that the IRS likewise provided no rationale in the final regulations.[12]

IRS Rules That Shares in Money Market Fund Qualify as Cash Items For REITs

At the close of each quarter of its taxable year, at least 75% of the value of a real estate investment trust (REIT)'s total assets must be represented by real estate assets, cash, and cash items (including receivables) and/or government securities.[1] Additionally, at the end of each quarter of a taxable year, not more than 25% of the value of a REIT's total assets may be represented by securities (other than those includible under §856(c)(4)(A) of the Code).[2] Subject to certain exceptions, no more than 5% of the REIT's total assets may be represented by securities of any one issuer, and that a REIT may not hold securities possessing more than 10% of the total voting power or value of the outstanding securities of any single issuer.[3] The term "cash items" is not defined in the Code. While all terms that are not defined in §856(c)(5) of the Code have the same meaning as when used in the Investment Company Act of 1940 (15 USC 80a-1 *et seq.*) (the "1940 Act"),[4] as amended, the term "cash item" is not defined in either the 1940 Act or the regulations under the 1940 Act.

In Rev. Rul. 2012-17,[5] the IRS ruled that the shares in a money market fund held by a real estate investment trust (REIT) were "cash items" for purposes of §856(c)(4)(A) of the Code.

Taxpayer elected to be taxed as a REIT under §§856 through 860 of the Code. During the first quarter of its 2011 taxable year, Taxpayer purchased shares in a money market fund. The money market fund was subject to regulation under the 1940 Act.[6] At the close of the first quarter of its 2011 taxable year, 20% of the value of Taxpayer's total assets was represented by securities that were not government securities, real estate assets, or cash or cash items, 7% was represented by the shares in the money market fund, and 73% was represented by assets that are real estate assets.

Because the term "cash items" is not defined in the Code or in the Investment Company Act of 1940, the IRS turned to the definition as set forth in a Securities and Exchange Commission (SEC) no-action letter.[7] In that no-action letter, the SEC determined that an issuer "may treat money market fund shares as 'cash items,' and not as investment securities and adjusted investment securities . . . for purposes of determining whether the issuer is an investment company" under the Investment Company Act of 1940 and the regulations thereunder. In support of its conclusion, the SEC noted that "the essential qualities of a cash item . . . [are] a high degree of liquidity and a relative safety of principal" and that money market fund shares had "these same qualities because of the specific regulatory requirements with which money market funds must comply."

The IRS determined that the conclusion reached in the SEC no-action letter was not inconsistent with the language of §856(c)(4)(A) of the Code or its underlying legislative history. Accordingly, the IRS ruled that Taxpayer's shares in the money market fund were "cash items," and, therefore, Taxpayer satisfied the 75% value test under §856(c)(4)(A) of the Code. In addition, as an investment that is includible under §856(c)(4)(A) of the Code, the IRS concluded that Taxpayer's shares in the money market fund were not

[10] 463 U.S. 29, 43 (1983).

[11] Notice 88-99, 1988-2 C.B. 422.

[12] 59 Fed. Reg. 67187 (12/29/94).

[1] §856(c)(4)(A). Except as otherwise indicated, references to "§" are to sections of the Internal Revenue Code (the "Code") and the regulations issued thereunder.

[2] §856(c)(4)(B).

[3] *Id.*

[4] §856(c)(5)(F).

[5] 2012-25 I.R.B. 1018.

[6] 15 USC 80a-1, *et seq.*

[7] *See* Willkie Farr & Gallagher, SEC No-Action Letter, IM Ref. No. 2000 10 24 1124, File No. 132-3 (10/23/00), viewable at *http://www.sec.gov/divisions/investment/noactionwillkiefarr gallagher102300.pdf.*

© 2012 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

treated as investments in securities for purposes of §856(c)(4)(B) of the Code.

IRS Office of Chief Counsel Advises That Permanently Moored Riverboat Casino Must Be Depreciated as Real Property

Section 167(a) of the Internal Revenue Code (the "Code"), allows as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear and obsolescence of property used in a trade or business or held for production. The depreciation deduction for tangible property placed in service after 1986 generally is determined under §168 of the Code, which prescribes two methods of accounting for determining depreciation allowances: (1) the general depreciation system in §168(a), and (2) the alternative depreciation system in §168(g). Under either depreciation system, a taxpayer computes the depreciation deduction by using a prescribed depreciation method, recovery period and convention. The applicable recovery period for purposes of either §168(a) or 168(g) is determined by reference to class life or by statute.

In CCA 201225012, the IRS Office of Chief Counsel concluded that a taxpayer's floating riverboat casino was classified as nonresidential real property under §168(e) and thus had a 39-year recovery period for §168(a) purposes and 40-year recovery period for §168(g) purposes.

By state law, riverboat gambling was permitted but land-based gaming operations were prohibited. The state issued a license to Taxpayer for a riverboat. Taxpayer cut a basin alongside a river to accommodate its riverboat casino. Taxpayer owned the land on which the dock, including the pavilion through which patrons enter the riverboat casino and the inherently permanent moorings to which its riverboat casino was affixed. Although Taxpayer's riverboat casino was capable of cruising the river, it had never been moved since being motored into position. In 2009, the U.S. Coast Guard announced that, in light of the decision in *Stewart v. Dutra Construction Co., Inc.*,[1] it would no longer inspect permanently moored craft unless it was used, or was practically — not merely theoretically — capable of being used, as a means of transportation on water. Taxpayer unsuccessfully protested the U.S. Coast Guard's determination that its riverboat casino was not a water vessel.

Rev. Proc. 87-56[2] sets forth the class lives of property that are necessary to compute the depreciation allowances under §168 of the Code. The IRS Office of Chief Counsel noted that Asset Class 00.28 includes "vessels, barges, tugs, and similar water transportation equipment, except those used in marine construction," but does not include any further description. Section 7701(o)(1)(7)[3] of the Code refers to the 1 USC §3 definition of "vessel," which includes watercraft or other similar craft used, or capable of being used, as a means of transportation on water. In *Stewart*, the Supreme Court concluded that the 1 USC §3 definition of "vessel" controlled, but that a watercraft is not "capable of being used" if it is "permanently moored or otherwise rendered practically incapable of transportation or movement."[4]

On March 12, 2001, the IRS issued an Industry Specialization Program Coordinated Issue Paper, entitled "Class Life of Floating Gaming Facilities UIL 168.20-07 ("CIP"), which described two contrasting gaming facility fact patterns — a casino riverboat and a casino facility-in-a-moat. The CIP also set forth 20 factors for determining whether a floating gaming facility is a vessel described in Asset Class 00.28, including whether it is registered with the Coast Guard or similar governmental authority and certified by the Coast Guard as a seaworthy vessel. Based on the *Stewart* opinion and the CIP, the IRS Office of Chief Counsel concluded that Taxpayer's riverboat casino was not a vessel because it had been permanently moored and the Coast Guard was no longer inspecting or registering it.

The IRS Office of Chief Counsel then considered whether Taxpayer's riverboat casino was classified in Asset Class 79.0, Recreation, of Rev. Proc. 87-56 or as nonresidential real property. Asset Class 79.0 includes "assets used in the provision of entertainment services on payment of a fee or admission charge, as in the operation of bowling alleys, billiard and pool establishments, theaters, concert halls, and miniature golf courses, but does not include buildings which house the assets used in entertainment services." Additionally, the CIP stated that Asset Class 79.0 included gaming activities. Assets used primarily in Asset Class 79.0 have a recovery period of 7 years for purposes of §168(a) and 10 years for purposes of §168(g). Conversely, nonresidential real property has a recovery period of 39 years for purposes of §168(a) and 40 years for purposes of §168(g). Nonresidential real property is defined by reference to §1250 of the Code and Regs. §1.48-1(e) to include buildings. Factors to be considered in determining whether a struc-

[1] 543 U.S. 481 (2005).

[2] 1987-2 C.B. 674.

[3] As in effect on March 29, 2010 (the day before the enactment of the Health Care and Education Reconciliation Act of 2010).

[4] *Stewart*, 543 U.S. at 494.

© 2012 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

ture is a building include its appearance, its function, and its inherent permanency.[5]

For purposes of determining whether a structure is inherently permanent, the Tax Court in *Whiteco Indus., Inc. v. Comr.*,[6] set forth the following six factors: First, is the property capable of being moved, and has it actually been moved? Second, is the property designed or constructed to remain permanently in place? Third, are there circumstances, which show that the property may or will be moved? Fourth, how substantial a job is removal of the property and how time consuming is it? Fifth, how much damage will the property sustain upon its removal? Sixth, what is the manner of affixation of the property to the land?

The IRS Office of Chief Counsel concluded that the first factor weighed in favor of Taxpayer because, while the riverboat casino has not in fact been moved since being put into place, it is capable of being moved. It concluded that the second factor weighed in favor of the IRS because the riverboat casino was designed to be permanently attached to the land-based pavilion, which contains restaurants, shops, and gaming-related facilities. With regard to the third factor, the IRS Office of Chief Counsel concluded that it weighed in favor of the IRS because the riverboat casino was securely moored to the dock and did not float freely in the river. The IRS Office of Chief Counsel concluded that the fourth factor was inconclusive because, while Taxpayer maintained the boat could be unmoored from the dock in less than one hour, this process included a number of steps. With respect to the fifth factor, the IRS Office of Chief Counsel concluded that it weighed in favor of Taxpayer because the riverboat would not sustain much actual damage upon its removal. Finally, the IRS Office of Chief Counsel concluded that the sixth weighed in favor of the IRS because the mooring, together with the construction and the integration of the riverboat, demonstrate the expectation that it would remain in place indefinitely.

The IRS Office of Chief Counsel advised that Taxpayer's riverboat casino was a building under Regs. §1.48-1(e)(1) because the six factors weighed in favor of that characterization. As such, it was outside Asset Class 79.0 and instead should be classified as nonresidential real property under §168(e)(2). Accordingly, IRS Office of Chief Counsel advised that the riverboat had a recovery period of 39 years for purposes of §168(a) and 40 years for purposes of §168(g).

---

[5] *See L.L. Bean, Inc. v. Comr.*, T.C. Memo 1997-175.

[6] 65 T.C. 664, 672–73 (1975).

© 2012 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 8755-0628

READERS' SUBMISSIONS INVITED

We welcome the submission of articles of any length, notes, comments, reviews, and letters to the editor concerning the taxation of real estate transactions, partnership taxation, and real estate financing. Manuscripts for publication, and correspondence relating to them, should be sent to:

David Kempler, Esq.

Buchanan Ingersoll & Rooney PC

1700 K Street, N.W., Suite 300

Washington, D.C. 20006

Phone: (202) 452-7946

E-mail: david.kempler@bipc.com

While the utmost care will be given all manuscripts submitted, we cannot accept responsibility for unsolicited manuscripts. Articles accepted for publication are subject to editorial revision.