2023 YEAR-END TAX PLANNING GUIDE

REAL ESTATE

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This guide identifies tax strategies and considers how they may be influenced by recent administrative guidance and potential legislative changes that remain under consideration. Unless otherwise noted, the information contained in this article is based on enacted tax laws and policies as of the publication date and is subject to change based on future legislative or tax policy changes.

The structuring of real estate transactions can have significant tax implications, and new regulatory or statutory developments can change the calculation of how best to approach a transaction from a tax perspective. As part of year-end planning and looking ahead to the coming year, real estate businesses should review how current tax rules apply to their transactions and the effects of any changes to those rules – including the following:

- Evaluate Structure and Tax Consequences of Real Estate Debt Workout Transactions
- Prepare for Proposed Limit on Domestically Controlled REIT Status That Would Subject More Foreign Investors to U.S. Tax
- Consider Electing Real Property Business Exception from Section 163(j) Business Interest Expense Limitation

Evaluate Structure and Tax Consequences of Real Estate Debt Workout Transactions

In a recent memorandum decision, the Tax Court has held that a taxpayer had Section 1001 gain or loss, and not cancellation of debt (COD) income, with respect to the sale of real property subject to a nonrecourse loan that was cancelled or retired as part of the sale transaction (Parker v. Commissioner, T.C. Memo 2023-104).

This decision serves as a reminder of the importance of properly evaluating and structuring a debt workout transaction in light of possibly alternative federal income tax consequences.

Based on the particular facts and circumstances, taxpayers may wish to consider whether such a transaction can be structured to generate COD income or Section 1001 gain. For example, a taxpayer may be eligible for one or more exceptions to the recognition of COD income under Section 108. Full or partial exclusion of COD income may be more beneficial than recognition of capital gain resulting from a Section 1001 transaction. Structuring a transaction to achieve either capital gain or COD income is complex with numerous pitfalls and traps for the unwary.

Tax Treatment of Recourse Versus Nonrecourse Debt

It is essential to understand the difference in the income tax treatment of retirement or cancellation of recourse versus nonrecourse debt as part of a sale or exchange of the underlying property collateral.

If the debt is nonrecourse, the gain will generally be Section 1001 gain or loss (generally capital gain or Section 1231 gain, assuming the real property collateral is not dealer property), rather than COD income, which is characterized as ordinary income.

Conversely, if the debt is recourse, there will be COD income to the extent the debt balance exceeds the fair market value of the real property collateral, and Section 1001 gain or loss to the extent the fair market value exceeds (or falls short of) the adjusted tax basis in the property.

Alternatively, if a nonrecourse loan is not retired but instead is substantially modified and assumed or taken subject to by the buyer, the transfer may trigger COD income that generally will be allocated to the seller under Reg. §1.1274-5(b).

Similarly, COD income can be generated from a substantial modification of a nonrecourse loan that is not part of a sale or exchange of the underlying real property collateral.

Gross Income Exclusions

COD income may qualify for one of several gross income exclusions under Section 108, e.g., the exclusion for qualifying real property business indebtedness under Section 108(c). Conversely, Section 1001 gain does not qualify for any such exclusion.

Determining Whether Debt Is Recourse or Nonrecourse

Determining whether a debt is recourse versus nonrecourse is not always easy. For this purpose, the Section 1001 regulations provide guidance as to whether a liability is recourse versus nonrecourse. When analyzing a partnership debt workout, the definition of recourse versus nonrecourse under Section 752 should generally not be used.

In contrast to Section 752 where recourse versus nonrecourse is determined based on the partners' economic risk of loss, the determination of recourse versus nonrecourse status under Section 1001 depends on whether the creditor's rights are limited to a particular asset or group of assets. Recourse indebtedness for Section 1001 means all the debtor's assets may be reached by creditors if the debt is not paid while nonrecourse indebtedness is where the creditor's remedies are limited to the collateral for the debt. See Raphan v. United States, 759 F.2d 879 (Fed. Cir. 1985).

Depending on the facts (e.g., a full recourse loan to a limited liability company with no guarantees by the LLC members or their affiliates), it may be unclear whether debt is recourse or nonrecourse for Section 1001 purposes. The Tax Court in Great Plains Gasification Associates v. Commissioner, T.C. Memo 2006-276, agreed with the IRS when it appeared to argue that Section 752 and the regulations thereunder determine whether partnership debt is characterized as recourse or nonrecourse. However, the IRS appeared to reverse its position in CCA 201525010, when it ruled that the implication created by Great Plains Gasification was erroneous. The IRS further stated that Section 752 is limited to determining the partners' basis in the partnership. As primary authority for this conclusion, the IRS cites Reg. §1.752-1(a), which states that the definitions of recourse and nonrecourse liabilities found in this paragraph only apply "for purposes of Section 752." In some cases, it may be possible to conclude that there is substantial authority for either position.

Planning Considerations

Taxpayers may prefer COD income to capital gain or vice versa depending on the taxpayer's specific situation. For example, a taxpayer may prefer COD income if the taxpayer is insolvent, in bankruptcy, or otherwise eligible for another COD income exclusion. Another taxpayer who is eligible for the lower capital gains rates, but not eligible for a COD income exclusion, would generally prefer capital gain to COD income.

There may be tax planning opportunities in these situations. Key factors to be considered include the following:

- Is there a preference for COD income over capital gain?
- Is any property being transferred as a result of the workout?
- Is the liability recourse or nonrecourse?

With careful and proactive planning, achieving desired results may be possible. For example, if the taxpayer would prefer COD income where the debt is nonrecourse, the debtor could negotiate a reduction of the debt. The forgiveness of all or a portion of a nonrecourse debt without the transfer of the collateral will result in COD income rather than gain from the sale of the property. Alternatively, the debtor could possibly transfer cash equal to the fair value of the collateral instead of transferring the collateral to the lender. In Gershkowitz v. Commissioner, 88 T.C. 984 (1987), the Tax Court appeared to allow results similar to these situations.

However, in a later opinion, 2925 Briarpark, Ltd. V. Commissioner, T.C. Memo 1997-298, aff'd 163 F.3d 313 (5th Cir. 1999), the Fifth Circuit Court of Appeals in affirming the Tax Court decision held against the taxpayer where the lender had agreed to release the property from all liens if the debtor sold the property for a minimum sales price. The court reasoned that the sale of the property and the cancellation of the debt were too closely intertwined to be treated as two separate transactions. Therefore, the debtor was required to recognize gain from the sale of the property rather than COD income.

These two court cases show that while not easy, it may be possible to accomplish a taxpayer's desired results through careful planning.

Prepare for Proposed Limit on Domestically Controlled REIT Status That Would Subject More Foreign Investors to U.S. Tax

Proposed Treasury regulations (REG-100442-22) issued in December 2022 would limit the eligibility of a real estate investment trust (REIT) to qualify as a "domestically controlled REIT," thereby curtailing – potentially retroactively – the common use of such structures to avoid U.S. income tax on foreign investors' gains on sales of REIT stock.

Many private real estate partnership funds hold U.S. real property through REITs. The general rule under Section 897(a)(1) and (c) is that gain to a foreign investor on the sale of a "United States real property interest" (USRPI) is treated as "effectively connected income" and, thus, is subject to U.S. income tax. For this purpose, under Section 897(c)(1) and (2), a USRPI includes stock of a "US real property holding corporation," which generally includes a REIT that holds U.S. real property as its primary asset.

However, U.S. income tax is generally not imposed if the REIT qualifies as a "domestically controlled REIT" (DC REIT), which includes a REIT in which less than 50 percent of the value of its stock was held, directly or indirectly, by foreign investors at all times during the REIT's existence during the five-year period preceding the sale of the REIT stock. Although attribution rules are provided in several other contexts under Section 897, the statute does not define the term "directly or indirectly" for this purpose.

It appears to be well accepted that the foreign status of a REIT's direct and indirect owners is determined by looking through to the partners in a U.S. partnership that owns stock of the REIT. By contrast, the IRS ruled in PLR 200923001 that a U.S. corporation owned by foreign investors is treated as a U.S. shareholder of the REIT, i.e., there is no look-through to the foreign shareholders of the U.S. corporation. Under this approach, foreign investors can own more than 50 percent of the stock of a DC REIT, i.e., 49 percent directly and the balance indirectly through a U.S. corporation. Moreover, the favorable result in PLR 200923001 was cited with approval in the legislative history to section 322(b)(1)(A) of the Protecting Americans from Tax Hikes Act of 2015, Public Law 114-113, div. Q.

Accordingly, the REIT structure with foreign investors owning more than 50 percent of REIT stock, in part through a U.S. corporation, has been adopted by many private real estate partnerships in anticipation of the U.S. income tax exemption for foreign investors' gain on the sale of DC REIT stock.

On December 29, 2022, Treasury and the IRS issued Proposed Reg. §1.897-1(c)(3), which, if adopted in final form, would substantially curtail eligibility for DC REIT status. The proposed rule would require a look-through to the domestic or foreign status of the shareholders of a nonpublic U.S. corporation for this purpose unless the U.S. corporation is owned, directly or indirectly, less than 25 percent by foreign shareholders, in which case the U.S. corporation would qualify as a domestic REIT shareholder for this purpose. Moreover, this rule would effectively apply retroactively because of the five-year lookback in determining DC REIT status.

Planning Considerations

These proposed DC REIT regulations have caused a fair amount of controversy, and Treasury has indicated that it is considering how the effective date provisions might be changed to grant relief from the retroactive effect of the regulations.

Nevertheless, it would appear prudent to avoid excess foreign direct and indirect ownership of a REIT for which the foreign shareholders may be seeking favorable U.S. income tax treatment on stock sale gains. Companies should assess the risks and opportunities that may be available through DC REIT status.

Consider Electing Real Property Trade or Business Exception from Section 163(j) Business Interest Expense Limitation

Some taxpayers engaged in construction and other real property trades or businesses that are subject to the business interest expense limitation under Internal Revenue Code Section 163(j) may benefit from making the real property trade or business election. There are some key factors to review when considering this potentially underused election.

Section 163(j) Business Interest Expense Limitation

Enacted changes to Section 163(j) provided a new limitation on the deduction for "business interest expense" of all taxpayers unless a specific exclusion applies under Section 163(j). Section 163(j) generally limits the amount of business interest expense that can be deducted in the current year and is effective for tax years beginning after December 31, 2017. Under Section 163(j)(1), the amount allowed as a deduction for business interest expense is limited to the sum of (1) the taxpayer's business interest income for the taxable year; (2) 30% of the taxpayer's adjusted taxable income (ATI) for the taxable year; and (3) the taxpayer's floor plan financing interest expense for the taxable year.

The term ATI means the tentative taxable income of the taxpayer adjusted for various items including business interest expense and net operating loss deductions, among others. For taxable years beginning on or after January 1, 2022, a taxpayer is no longer allowed to add back depreciation and amortization in calculating ATI. As a result, more taxpayers are being subjected to the Section 163(j) business interest expense limitation. Therefore, it is more important to determine whether a taxpayer qualifies for a specific exclusion from Section 163(j).

Section 163(j)(3) provides an exemption for certain small businesses if the average annual gross receipts of such entity for the three-taxable-year period ending with the taxable year which precedes such taxable year does not exceed $25 million ($29 million for taxable years beginning in 2023). Aggregation rules apply when determining the annual gross receipts limitation.

Real Property Trade or Business Election

Of particular interest to taxpayers in the real estate industry who do not qualify for the small business exemption is the electing real property trade or business (RPTOB) exception under Section 163(j)(7)(B). Any trade or business which is described in Section 469(c)(7)(C) and which makes an election under Section 163(j)(7)(B) is eligible for this exception. Taxpayers who make a RPTOB election are required to use the alternative depreciation system (ADS) for nonresidential real property, residential real property, and qualified improvement property (QIP).

The real property trades or businesses listed in Section 469(c)(7)(C) include any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.

Planning Considerations

Real estate businesses that fall into the above categories and have interest limited under Section 163(j) should consider whether it is beneficial to file a RPTOB election. The RPTOB election may be underutilized for certain taxpayers such as taxpayers in the construction and management industries. Additionally, since these types of real estate companies may not own significant real property, there may be very little to no downside for making the election in the form of reduced depreciation deductions.

The RPTOB election is made for each trade or business of a taxpayer. Therefore, if a taxpayer has more than one trade or business and one or more of the taxpayer's trades or businesses are not eligible to make the RPTOB election or the taxpayer chooses not to make the RPTOB election for an eligible trade or business, the taxpayer must allocate interest expense, interest income, and other items of expense and gross income between the taxpayer's excepted and nonexcepted trades or businesses. The allocation rules for this purpose are complex and are detailed in Reg. Section 1.163(j)-10.

Depreciation Considerations

As mentioned above, if a taxpayer has made a RPTOB election out of the Section 163(j) business interest expense limitation, the taxpayer must use ADS under Section 168(g) for nonresidential real property, residential real property, and QIP.

QIP is defined under Section 168(e)(6) as "any improvement made by the taxpayer to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date such building was first placed in service" ¬¬– but not including any improvement for which the expenditure is attributable to (i) the enlargement of the building, (ii) any elevator or escalator, or (iii) the internal structural framework of the building. QIP is depreciable over a MACRS recovery period of 15 years.

If the taxpayer has not made a RPTOB election and is not otherwise required to use ADS, the taxpayer's cost of QIP may qualify for bonus depreciation. The bonus depreciation percentage is 100% for property placed in service before 2023 and 80% for property placed in service after December 31, 2022, and before January 1, 2024.

However, if a taxpayer has made a RPTOB election, the taxpayer is required to use ADS for QIP and the taxpayer's cost of QIP would not qualify for bonus depreciation. The ADS recovery period for QIP is 20 years.

It is important to analyze the effect a RPTOB election may have on the depreciation deductions of a taxpayer in order to quantify the potential benefits of making the election.

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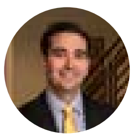

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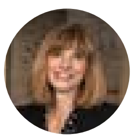

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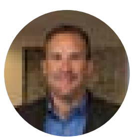

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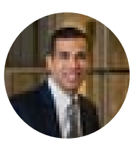

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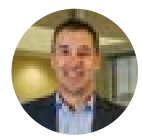

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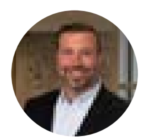

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