CURRENT TAX ISSUES FOR THE SHOPPING CENTER INDUSTRY

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GLENN M. JOHNSON, ERNST & YOUNG LLP

STEVEN R. SCHNEIDER, GOULSTON & STORRS P.C.

Overview

- Lease structuring
- Like-kind exchanges
- Bonus depreciation
- Update from DC
  - Recent legislation including Carried Interests
  - Recent cases and regulations affecting real estate

Lease Structuring

- **What is a Lease for Federal Income Tax Purposes?**
  - **True Lease –** lessor is property owner for tax
  - **Synthetic lease -** "operating lease" under U.S. GAAP principles, but debt financing under U.S. Tax principles
  - **Double Dip/hybrid lease** - debt financing for U.S. tax purposes, but a lease under foreign tax principles

Lease Structuring

- **Rules for determining tax treatment**
  - "benefits and burdens of ownership," irrespective of the form of the transaction
    - Burdens: significant equity investment by the lessor subject to economic deterioration over the lease term
    - Benefits: Expected residual value

Frank Lyon factors

- Who holds title?
- How did the parties treated the transaction?
- Is there a present obligation to deliver title and purchase price?
- Does the lessor have equity in the property?
- Is the purchase price FMV?
- Does lessor have risk of loss?
- Does the useful life extend beyond the lease term?

Frank Lyon factors

– Does lessor have profits from ultimate property sale?
– Does lessee have below FMV purchase option?
– Are rent renewals set at FMV?
– Can lessor recoup investment from income producing potential and residual value?

IRS Safe Harbor on True Lease

- Rev. Proc. 2001-28 provides what the IRS requires to receive an advanced ruling on true lease characterization. See also Rev. Rul. 55-540.
  - *Initial Minimum Investment.* When placed in service, at least 20 percent of the property's cost.
  - *Maintenance of Minimum Investment*. At least 20 percent of the cost of the property at all times throughout the entire lease term.
  - *Residual Investment*. At least 20 percent of the original cost.

IRS Safe Harbor on True Lease

- Purchase and Sale rights
  - No member of the Lessee Group may be provided a contractual right to purchase the property from the lessor at a price less than its FMV at the time the right is exercised.
- No investment by lessee
- No Lessee Loans or Guarantees
- Lessor must demonstrate it expects to receive a profit
- Other rules: uneven rent, limited use property

Lease vs. Service Contract -§7701(e)

- Service provider is in physical possession of the property
- Service recipient controls the property;
- Service recipient has a significant economic or possessory interest in the property;
- Service provider does not bear risk if there is nonperformance under the contract;
- Service provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient; and
- Total contract price does not substantially exceed the rental value of the property for the contract period.

Lease v. Partnership

- Risk-Sharing
- Revenue-Sharing
- Cost/Profit-Sharing

Construction Allowance for Tenant Improvements

- Initial inquiry - treatment as an allowance or as a rent adjustment.
- Section 110 avoids tenant's taxable income if used for qualifying construction of leasehold improvements.
- Landlord Payments of Tenant Allowances

Section 467

- Intent
  - Certain lessors and lessees should report rents under an accrual basis.
- When is Section 467 applicable?
  - Leases of tangible property.
  - Rental Payments Uneven
  - 467 Rental Agreement if:
    - Increasing or decreasing rent
    - Prepaid or deferred rent

Section 467

- Exceptions to Increasing or Decreasing Rent
  - Rent Holiday
  - Certain Contingent Rent

Section 467

- Rental Accrual Methods
  - Proportional Rental Accrual
    - Prepaid or deferred rent
    - Allocation schedule that is different than payment schedule
    - If no interest component, creates Section 467 loan
  - Constant Rental Accrual
    - Increasing or decreasing rent
    - Long-term agreement or leaseback
    - Only IRS can apply
    - Creates Section 467 loan

Like-kind exchanges

What is really required to do a like-kind exchange?

Typical steps in QI exchange

- Contract negotiations
- Enter Exchange Agreement with QI
- Assign rights in contracts to QI
- Notify parties of assignment
- Transfer/Acquire property
- Money transferred to QI and used to purchase new replacement property

§1031: General Requirements

- The taxpayer must "exchange" the relinquished property for replacement property. §1031(a)(1).
- Relinquished and replacement property must both be held for productive use in a trade or business or for investment
- The relinquished property and replacement property must be of "like kind"

§1031: General Requirements

- The taxpayer must "identify" the replacement property no later than 45 days after the date on which the taxpayer transfers the relinquished property through the QI.
- The replacement property must be "received" by the taxpayer (through the QI) no later than the earlier of: (i) 180 days after the date on which the taxpayer transfers the relinquished property through the QI and (ii) the due date (including valid extensions) for the taxpayer's tax return.

Excluded Property Types

- **inventory or other property held primarily for sale;**
- **stock, bonds, or notes;**
- **other securities or evidences of indebtedness or interest;**
- **interests in a partnership;**
- **certificates of trust or beneficial interests;**
- **choses in action;**
- **certain tax-exempt use property.**

Related Party Considerations

- The replacement property generally must not be acquired (through the QI) from a related person. §1031(f)(1)&(4).
- If relinquished property is transferred (through the QI) to a related person, the related person must generally hold the property for at least two years. §1031(f)(1)&(4).

Gain Recognition

- **In a qualifying like-kind exchange, gain is recognized to the extent of money and the fair market value of other non-like-kind property ("boot") received in the exchange.**
- **Special rule on gain from multiple properties.**
- **Need sufficient section 1245 or 1250 property to avoid gain from recapture.**

Tax Basis in Replacement Property

- **The taxpayer effectively obtains a basis in the replacement property that is equal to the fair market value of the property less the amount of gain deferred in the exchange.**

Bonus Depreciation

Bonus Depreciation Basics

- Barring any election out of bonus depreciation being made, calendar year taxpayers will generally be subject to two different layers of bonus depreciation in 2010 –
  - (1) 50% bonus depreciation for otherwise qualified property placed in service between January 1, 2010, and September 8, 2010, and
  - (2) 100% bonus depreciation for otherwise qualified property placed in service between September 9, 2010, and December 31, 2010.

Bonus Depreciation Basics

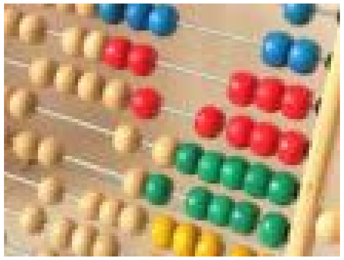
- 50% bonus depreciation applies to property:
  - (i) to which Section 168 applies and that has a recovery period of 20 years or less, that is computer software, that is water utility property, or that is qualified leasehold improvement property;
  - (ii) that has an original use that commences with the taxpayer after December 31, 2007;
  - (iii) that is acquired by the taxpayer after December 31, 2007, and before January 1, 2013, but only if no binding written contract was in place before January 1, 2008; and
  - (iv) is placed in service before January 1, 2013 (January 1, 2014, if the property is long production period property or certain aircraft).

Bonus Depreciation Basics

- 100% bonus depreciation applies (in addition to those provided in Section 168(k)(2)(A)):
  - if such property is acquired by the taxpayer after September 8, 2010, and before January 1, 2012 (January 1, 2013, for long production period property and certain aircraft);
  - if such property is placed in service after September 8, 2010, and before January 1, 2012 (January 1, 2013, for long production period property and certain aircraft); and
  - the original use of such property commences with the taxpayer after September 8, 2010.

Updates from Washington DC – Prospective Legislation

Carried Interest



- What is it? It's the promote!

- How is it taxed now? Often long-term capital gain at 15% federal tax rate.

- How would it be taxed? Ordinary service income including social security taxes.

The Three Proposals

Proposed Ordinary Income Percentages For Carried Interest			
	2010 House Version	2010 Senate Version	2011 Obama Version
2011-2012	50% ordinary income	75% ordinary income	100% ordinary income
2013 and later	75% ordinary income	75% ordinary income	100% ordinary income
2011 and later gain from assets held 5 plus years	75% ordinary income	50% ordinary income	100% ordinary income

Take Aways

- The legislation would raise tax rates, even on existing deals.
- The legislation denies deductions, raising taxes even without a sale.
- The legislation might tax the developer on property distributions and interest transfers.
- Carried Interests may include the developer's side-by-side equity.

Current Carried Interest Tax Proposals*

- Effective Date: [Obama version: taxable years after 12/31/2012]
- Applies to old and new partnerships (no grandfathering)
- Applies to persons (or related persons) who:
  - Directly or indirectly provide substantial investment, management or financial services; [Obama version broader]
  - Services relate to certain investment assets (including rental and investment real estate) held directly/indirectly by the partnership

*Most of the discussion in this material relates to Senate 2010 version, some changes in Obama's 2011 version

Tax Acceleration

Tax on Carried Interest is accelerated if:

- Carried Interest holder transfers Carried Interest (even transfers to family partnerships or REIT operating partnerships)
- Carried Interest holder receives property distributions from the partnership
- Partnership merges into another partnership

In limited cases the Carried Interest holder can elect to avoid the gain if the Carried Interest taint is carried over to the new partnership.

Loss Limitation Rule

- Tax losses otherwise flowing through 100%/75%/50% tainted portion of Carried Interest are deferred and can only be used against future Carried Interest income from that specific partnership
- The idea is that Carried Interest is compensation income and should not receive tax losses like an investment
- Under current law, real estate developers often receive tax losses because they are at risk for debt-guarantees, but this legislation would limit the developer's losses

Qualified Capital Exception

- Carried Interest holder can exclude “Qualified Capital” that is intended to be the “side-by-side” capital such holder puts in with the investors
- Use of loans from investors to Carried Interest holder does not circumvent this rule

Other Obama Proposals

- Cap itemized deductions for upper-income taxpayers at 28 percent;
- Expiration of the 2001 and 2003 tax cuts for upper-income taxpayers at the end of 2012;
- Tax qualified dividends and net long-term capital gains at 20% marginal rate;
- Reintroduction of carried interest tax;

Other Obama Proposals

- Substantially simplify the "fractions rule" for real estate investments involving certain tax-exempt organizations;
- Repeal preferential dividend rule for publicly traded REITs; and
- Replace §179D with energy efficient tax credit for commercial buildings.

REIT Update

- Safe harbor REIT guidance for underwater loan modifications. *Rev. Proc. 2011-16*.
- IRS disregards REIT's share of REIT loan to partnership. *PLR 201118015*.
- IRS allows second class of REIT stock with different fee structure. *PLR 201109003.*

General Real Estate Developments

- IRS guidance on 100% bonus depreciation. *Rev. Proc. 2011-26*.
- Treasury report recommends more tax audits of rental real estate losses. *TIGTA Report dated December 20, 2010*.
- Simplified late election procedures under section 469 for real estate professionals to group limited partner interests. *Rev. Proc. 2011-34*.

Workouts and Cancellation of Debt

- Proposed regulations address how to apply COD exceptions for disregarded entities. *REG-154159-09.*
- IRS finalizes favorable debt vs. equity rule in debt modifications. *Treasury Decision 9513*.

Workouts and Cancellation of Debt

- Temporary regulations address COD income deferral rules. *Treasury Decisions 9497 and 9498.*
- IRS proposes rules on testing for publicly traded debt. *REG-131947-10*.

Disclaimer & Contact Information

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Steven R. Schneider
Goulston & Storrs PC
1999 K Street N.W., Suite 500
Washington DC 20006
Direct (202) 721-1145
sschneider@goulstonstorrs.com

Glenn Johnson
Ernst & Young LLP
1101 New York Avenue, N.W.
Washington, DC 20005
Direct (202) 327-6687
glenn.johnson@ey.com