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Opportunities and Pitfalls in Structuring UPREIT Transactions

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As certain segments of the real estate market have started to heat up after the doldrums of the economic downturn, real estate investment trusts ("REITs") have been major players in the resulting transactions. The significance of tax consequences in these transactions has been highlighted in recent economic times as the tightening of the debt markets has generated a liquidity crisis in which many real estate owners may be under pressure to sell, but unable to withstand a heavy tax burden accompanying the disposition of their property. Also, declines in property values have resulted in the potential tax bill on dispositions of real estate often comprising an increased percentage of net equity of the properties.

These pressures have contributed to the beginnings of a revival of transactions with umbrella partnership real estate investment trusts ("UPREITs") in which real estate is contributed to the umbrella partnership. These transactions were commonplace upon their advent in the mid-90s and in the years that followed, but have long since tapered off. They are advantageous in that they provide a mechanism for real estate owners to dispose of property in a tax-free transaction, and often are either more attractive or more practical than certain other potential tax-free transactions. For example, similar tax benefits could theoretically be realized in a transaction with a private equity fund, but private equity funds generally are loathe to accept restrictions on the disposition of the contributed property that are critical for maintaining tax deferral. In addition, while a section 1031 "like-kind" exchange can enable tax deferral, like-kind exchanges generally do not result in diversification or provide an easy exit strategy.

Although UPREIT deals are potentially attractive for a property owner, careful tax planning is critical in order to avoid both immediate and future adverse tax consequences. This article provides an overview of a typical UPREIT transaction, highlighting tax issues that must be considered and their impact on the manner in which these transactions are structured.

I. BACKGROUND

In the classic REIT format, the REIT owns real property either directly or through wholly-owned limited partnerships or limited liability companies that are disregarded as separate from the REIT for Federal income tax purposes. The advantage of this format is that it uses a simple structure. However, section 351(e) of the Internal Revenue Code[1] generally prevents contributors of property to a REIT from avoiding recognition of built-in gain (i.e., the excess of fair market value over tax basis) in the contributed property at the time of the contribution.[2] The UPREIT was developed in response to this problem.

In the UPREIT format, instead of the REIT owning property directly, all of the REIT's assets are indirectly owned through an umbrella partnership (the "operating partnership") of the REIT, and the REIT directly owns only interests in the operating partnership ("Units"). Typically, the REIT contributes cash (usually acquired in a public offering of shares) to the operating partnership in exchange for Units, and real estate owners contribute properties to the operating partnership in exchange for Units that are convertible into REIT shares at the option of the Unit-holder at a rate of one Unit per one REIT share. The cash contributed by the REIT is used to pay down debt, make improvements, acquire properties, and/or provide working capital. Since the contributors are transferring their property to a partnership, these contributions generally are tax-free under section 721 at the time of the contribution (subject to exceptions which will be discussed below). However, the contributors will recognize any built-in gain in the future upon exercising their right to convert their Units into REIT shares. Figure 1 illustrates a typical UPREIT transaction, and Figure 2 illustrates the UPREIT's structure after the contribution of the new property.

Figure 1: Contribution of a Property to an UPREIT

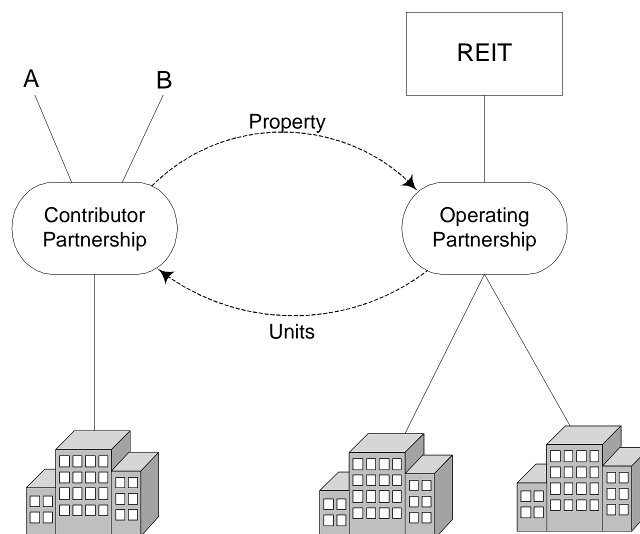
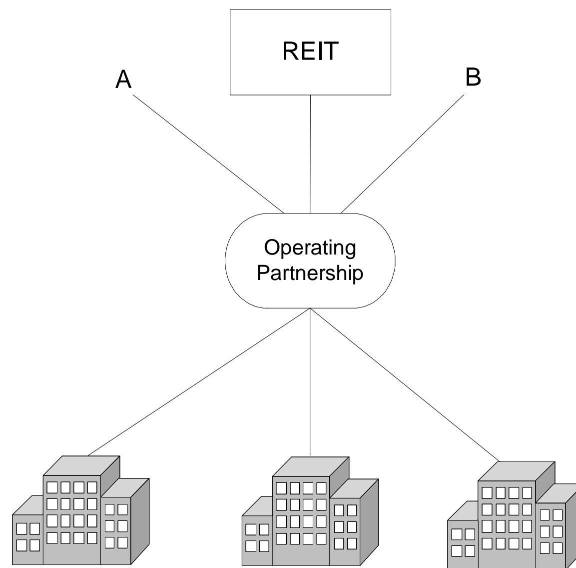


Figure 2: Post-Contribution Structure



II. UNIT DEAL TAX ISSUES

Suppose that a partnership which owns a property with built-in gain identifies a REIT in an UPREIT structure that wishes to purchase its property. If the partnership were to transfer the property directly to the REIT in exchange for either cash or REIT shares, the partnership would immediately recognize the built-in gain. However, the partnership can avoid current gain recognition by contributing the property to the REIT's operating partnership in exchange for Units (a transaction commonly referred to as a "Unit deal"). This contribution could consist of either (i) the partners in the property-owning partnership contributing their partnership interests to the operating partnership in exchange for Units or (ii) the property-owning partnership contributing the property to the operating partnership in exchange for Units followed by a liquidating distribution of the Units by the property-owning partnership to its partners.[3] Since tax deferral is a central objective of Unit deals, it is important to consider issues relating to both (i) having the contribution qualify for tax-free treatment under section 721 and (ii) avoiding future recognition of the contributor's built-in gain.

A. Partnership Disguised Sale Rules

In an UPREIT deal, the contributor of property to the UPREIT often wants to receive some cash as part of the transaction. However, a distribution of cash from the UPREIT to the contributor would implicate the partnership rules relating to "disguised sales" of property.

i. *Overview*

A contribution of property to a partnership is generally tax-free, and a distribution of cash from a partnership to a partner is generally tax-free to the extent of the partner's basis in its partnership

interest. However, section 707 and the Treasury Regulations (the "Regulations") thereunder provide that a partner's contribution of property to a partnership and a related distribution of money or other consideration from the partnership to the partner will generally be treated as a sale of property by the partner to the partnership under certain circumstances.[4] Specifically, these reciprocal transfers will generally be treated as a sale (a "disguised sale") if, when viewed together, they are "properly characterized as a sale or exchange of property."[5] Transfers between a partner and a partnership within two years of each other are presumed to be a disguised sale.[6]

ii. ***Exceptions to Disguised Sale Treatment***

The Regulations set forth several specific exceptions under which it may be possible for contributing partners to receive cash distributions from the operating partnership without jeopardizing the tax-free status of the contribution. Under one such exception, amounts that the contributor receives which are reimbursements for capital expenditures incurred with respect to the contributed property during the two-year period preceding the contribution are excluded from being treated as disguised sale proceeds if certain requirements are satisfied.[7] Also, it may be possible under certain circumstances for the contributing partner to receive a tax-free distribution of debt proceeds from the operating partnership.

iii. ***Assumption of Liabilities***

For purposes of the disguised sale rules, if a partner contributes property to a partnership and the partnership assumes or takes subject to a liability of the partner that is not a "qualified liability" (defined below), the partnership is treated as transferring money or other consideration to the partner for purposes of the disguised sale rules.[8] If the liability is a "qualified liability," then the partnership's assumption of or taking subject to the liability is not treated as part of a sale as long as the contribution of property would not otherwise involve a disguised sale.[9] However, if a transfer of property to a partnership is treated as part of a sale without regard to the partnership's assumption of or taking subject to a qualified liability, then the partnership's assumption of or taking subject to the qualified liability results in a deemed transfer of money or other consideration to the transferring partner as part of the sale.[10]

The term "qualified liability" is defined to include a liability assumed or taken subject to by a partnership in connection with a transfer of property by a partner to a partnership if any one of the following four criteria is met:[11]

- The liability (1) was incurred by the partner more than two years prior to the earlier of (i) the date the partner agrees in writing to transfer the property or (ii) the date the partner transfers the property to the partnership and (2) has encumbered the transferred property throughout the two-year period.[12]
- The liability was incurred by the partner within the two-year period referred to above, but (1) was not incurred in anticipation of the transfer of the property to the partnership and (2) has encumbered the transferred property since it was incurred.[13]
- The liability is allocable under the "interest-tracing" rules of Regulation section 1.163-8T to capital expenditures with respect to the property.[14]

- The liability was incurred in the ordinary course of the trade or business in which property transferred to the partnership was used or held, but only if all the assets related to that trade or business (other than assets that are not material to a continuation of the trade or business) are transferred.[15]

a. ***Assumption of Mortgage Debt***

The operating partnership often assumes, or takes subject to, mortgage debt as part of an UPREIT deal. If the mortgage debt has been outstanding for at least two years at the time of the transaction, then the mortgage debt generally will constitute a qualified liability. On the other hand, if the mortgage debt was incurred in the prior two years, then its characterization for disguised sale purposes may depend on how the borrowed funds were used. If they were used to invest in the property or to refinance debt on the property, then the mortgage debt generally will be a qualified liability. However, if the funds were used for most other purposes, the mortgage debt would be presumed not to be a qualified liability "unless the facts and circumstances clearly establish" that the mortgage debt was not incurred in anticipation of the transfer.[16] If debt proceeds are used for multiple purposes, part of a loan could constitute a qualified liability while another portion of the same loan could constitute a non-qualified liability.

b. ***Payment of the Contributor's Costs***

Some liabilities of a contributor that the operating partnership is considered to assume may be less obvious than mortgage debt. For example, payment by the operating partnership of the contributor's costs in connection with the transaction may also be treated as an assumption of liabilities by the operating partnership. This issue often arises in Unit deals where the operating partnership pays brokerage fees or transfer taxes with respect to the contributed property. Whether or not these payments cause the operating partnership to be considered to pay the contributor's costs generally depends on which party has primary liability. If primary liability rests with the contributor, then these payments by the operating partnership could be treated as a payment to the contributor as part of a disguised sale.

B. Debt Allocation and Partner Guarantees

i. ***Allocation of Debt Under Section 752***

Even if the operating partnership assumes only qualified liabilities from a contributor-partner in a property-owning partnership (i.e., there is no disguised sale), section 752 can nonetheless cause the contributor to recognize gain. Under section 752, any decrease in a partner's share of liabilities of a partnership is considered to be a distribution of money to the partner by the partnership. Therefore, the contributor will be considered to receive a cash distribution to the extent of the excess of (i) his share of the debt in the property-owning partnership prior to the transaction over (ii) his share of the operating partnership's debt after the transaction. Also, any future reduction in the contributor's share in the debt of the operating partnership would result in a deemed distribution of money under section 752. Upon a deemed distribution under section 752, the contributor would recognize taxable gain under section 731 to the extent (if any) that the deemed distribution exceeds the partner's adjusted tax basis in his partnership interest. In general, a contributor of property to an operating partnership will want to ensure that he will be allocated sufficient liabilities of the operating partnership so as to avoid the recognition of gain as a result of being relieved of liabilities in excess of basis.

Under the section 752 Regulations, nonrecourse liabilities are allocated to partners in a partnership in three separate "tiers." Under the first tier, each partner is allocated an amount of nonrecourse liabilities equal to the partner's share of partnership minimum gain pursuant to 704(b).[17] Under the second tier, each partner is allocated an amount of nonrecourse liabilities equal to the taxable gain that would be allocated to the partner under section 704(c) if the partnership disposed of (in a taxable transaction) all partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of the liabilities and for no other consideration.[18] Under the third tier, each partner's share of remaining nonrecourse liabilities ("excess nonrecourse liabilities") generally is determined in accordance with the partner's share of partnership profits.[19] However, since 2000, the Regulations have specified that a partnership may first allocate an excess nonrecourse liability to a partner up to the amount of built-in gain that is allocable to the partner on section 704(c) property subject to the nonrecourse liability (to the extent that this nonrecourse liability was not already allocated to the partner under the second tier).[20]

ii. ***Contributor Debt Guarantees***

In order to increase a contributor's share of liabilities in the operating partnership (and therefore the basis in his Units) sufficiently to avoid recognizing gain under section 752, a contributor may wish to guarantee a debt of the operating partnership. Such a guarantee will generally result in the guaranteed debt being treated as recourse debt which would be allocated to the partner who bears the risk of loss (i.e., the guarantor), and this additional debt share will increase the guarantor's basis in his partnership interest.[21] However, if recently released proposed regulations were to be finalized in their current form, partners would be significantly more restricted in their ability to have guaranteed debt allocated to them (e.g., the guarantee could not be a "bottom guarantee" and the partner would need to receive arms length consideration for making the guarantee).[22] In addition, even under current law, there is a risk that a guarantee provided by a thinly capitalized entity would not be respected for Federal income tax purposes.[23]

In addition, even where the section 752 debt allocation rules prevent the contributor from recognizing gain at the time of his contribution, his debt share may subsequently decrease in the future for a variety of reasons.[24] This subsequent decrease in the contributor's debt share sometimes could constitute a distribution in excess of basis which would result in gain recognition. As a result, it may be necessary for some contributors to negotiate for the opportunity to guarantee additional debt in the future.

In the case of some REITs, there may be a scarcity of "guaranteeable" debt, especially since many REITs have low leverage and have moved away from property-specific debt. Credit line debts are not ideal for guarantees since, by their very nature, they are reduced periodically. A reduction of the outstanding amount on a guaranteed credit line could result in gain to the guarantor as the result of a deemed distribution under section 752.

C. Lockout Provisions for Avoidance of Subsequent Gain Recognition

i. ***Overview of Section 704(c)***

As a result of the tax-free nature of the contribution of property to an operating partnership, the operating partnership receives a carry-over basis in the property. Pursuant to section 704(c), income,

gain, loss, and deduction attributable to property that is contributed to a partnership must be allocated for Federal income tax purposes in a manner such that the contributor is charged with, or benefits from, any unrealized gain or unrealized loss associated with the property at the time of contribution. The amount of this unrealized gain or unrealized loss is equal to the difference between the fair market value of the contributed property at the time of contribution and the adjusted tax basis of the property at that time. Unit deals frequently involve contributed properties with a substantial amount of unrealized gain. Because of prior depreciation deductions, this may be the case even if the contributed property has declined in value in economic terms.

ii. ***Lockout Periods***

The entire advantage of a tax-free contribution would be lost if the operating partnership were to turn around and sell the property the day after the contribution was made. In such a case, the operating partnership would realize the built-in gain and, pursuant to section 704(c), would specially allocate that gain to the contributor. To avoid this result, the contributor usually negotiates for a period of time during which the contributed property may not be sold (a "lockout period"). However, operating partnerships typically resist having their hands tied and, therefore, the length of the lockout period and the exceptions thereto often are hotly negotiated.

A typical lockout provision provides that, if the operating partnership sells the property during the lockout period, the operating partnership is required to indemnify the contributor for the tax consequences of the sale. (Note that, in order to make the contributor whole, the indemnity payment would have to be "grossed up" to account for the extra tax the contributor will incur on account of the indemnity payment.) Lockout provisions typically include an exception under which the operating partnership is permitted to dispose of the property in a tax-free exchange. Exceptions to the operating partnership's restrictions under a lockout provision may also include (i) a sale of the operating partnership's entire portfolio in the geographic area and (ii) involuntary transfers such as foreclosures or transfers made in connection with bankruptcy.

D. Section 704(c) Methods

Regulations under section 704(c) require partnerships to use a "reasonable method" for allocation of items affected by section 704(c) and provide three reasonable methods—the "traditional method," the "traditional method with curative allocations," and the "remedial method."[25] These methods impact the allocation of both (i) gain upon disposition of the contributed property and (ii) annual depreciation generated by the contributed property. The partnership's determination of which method to use is made on a property-by-property basis.[26]

In general, the "traditional method" allocates income, gain, loss, and deductions relating to contributed property in a manner such that, to the extent possible, each noncontributing partner is allocated tax items relating to the property equal to his book items relating to the property (which are based on the fair market value of the property at the time of the contribution).[27] However, the tax items relating to the property sometimes are insufficient to enable the partnership to make allocations to the noncontributing partners of tax items equal to their book items with respect to the property (a situation referred to as the "ceiling rule" problem). For example, even if all of the tax depreciation on the property is allocated to the noncontributing partners, these partners still may not receive tax depreciation on the property equal to

their book depreciation on the property. Both the "traditional method with curative allocations" and the "remedial method" (described below) provide for allocations that address the ceiling rule problem.

To illustrate the different 704(c) methods, suppose that A and B each contributes $5,000 to a newly formed partnership ("AB"). AB buys a property ("Property X") for $10,000 with a 10 year depreciable life and uses straight-line depreciation. Figure 3 depicts the balance sheet for AB upon its purchase of the property:

Figure 3
Initial Balance Sheet for AB

	Tax	Book
Property X	10,000	10,000
Capital		
A	5,000	5,000
B	5,000	5,000
	10,000	10,000

After five years, at a time when the property has a $5,000 tax basis and an unchanged fair market value of $10,000, AB contributes the property to an operating partnership (the "OP") of a REIT in an UPREIT format in exchange for 10% of the Units in the OP (with the remaining 90% of the Units owned by the REIT). AB then distributes these Units to A and B in complete liquidation of their interests in AB.[28] Assume that, aside from Property X, the OP's only other asset is Property Y, which is newly purchased depreciable property with a fair market value of $100,000, a tax basis of $100,000, and a useful life of 10 years. Figure 4 depicts the balance sheet for AB immediately prior to its contribution of Property X to the OP, and Figure 5 depicts the balance sheet for the OP immediately after the contribution.

Figure 4
Balance Sheet for AB After 5 Years of Depreciation

	Tax	Book
Property X	5,000	5,000
Capital		
A	2,500	2,500
B	2,500	2,500
	5,000	5,000

Figure 5
Balance Sheet for the OP Upon Contribution of Property X by AB

	Tax	Book	Book-Tax Difference
Property X	5,000	10,000	5,000
Property Y	100,000	100,000	0
	105,000	110,000	5,000
Capital			
A	2,500	5,000	2,500
B	2,500	5,000	2,500
REIT	100,000	100,000	0
	105,000	110,000	5,000

The OP would put Property X on its books with a $10,000 book value equal to the property's fair market value at the time of the contribution, but would have only a $5,000 carryover tax basis in the property. Therefore, for each of the five remaining years on the useful life of this property, there would be $2,000 of book depreciation and $1,000 of tax depreciation. The REIT would be allocated $1,800 (i.e., 90%) of the annual book depreciation on Property X, with the remaining $200 (i.e., 10%) allocated to A and B. As explained above, the traditional method allocates tax depreciation in a manner such that, to the extent possible, each noncontributing partner is allocated tax items relating to the property equal to his book items relating to the property. Thus, under the traditional method, the REIT would be allocated all $1,000 of the annual tax depreciation on Property X. However, the annual tax depreciation allocated to the REIT with respect to Property X would still be $800 less than the $1,800 of annual book depreciation with respect to Property X allocated to the REIT (i.e., an $800 annual ceiling rule problem).

The "traditional method with curative allocations" would address this ceiling rule problem by specially allocating other tax items.[29] For example, if the OP uses the traditional method with curative allocations with respect to Property X, it could specially allocate to the REIT an additional $800 of tax depreciation deductions from Property Y (that otherwise would have been allocated to A and B) annually for the five years remaining on the useful life of Property X.

The "remedial method" addresses the ceiling rule problem in a different manner from the traditional method with curative allocations—by generating remedial allocations (i.e., by creating new tax items to allocate to the partners). Another distinction between these two methods is that, as demonstrated below, the remedial method spreads out a portion of the book depreciation equal to the book-tax difference over a period equal to the entire useful life of the property. This distinction often causes contributing partners to prefer the remedial method over the traditional method with curative allocations.

To illustrate, if the OP uses the remedial method with respect to Property X, a portion of the annual book depreciation on this property equal to the $1,000 annual tax depreciation would be taken annually during the five years of the remaining useful life. The remaining $5,000 of the $10,000 of total book depreciation to be taken on Property X would be evenly spread over a period equal to the entire 10 year useful life of the property (i.e., $500 per year). Thus, the OP would have $1,500 of book depreciation on

Property X during each of the first five years ($1,000 + $500) and $500 of book depreciation on Property X during each of the subsequent five years. During each of the first five years, the REIT's 90% share of the $1,500 of book depreciation on Property X would be $1,350. Since there would be only $1,000 of tax depreciation on Property X during those first five years, (i) the OP would allocate all $1,000 of the annual tax depreciation to the REIT in those years and (ii) the OP would make annual remedial allocations of $350 of ordinary deductions to the REIT in those years (i.e., the excess of the REIT's $1,350 of annual book depreciation with respect to Property X over the $1,000 of annual tax depreciation with respect to Property X). The OP would also make an offsetting remedial allocation of $350 of ordinary income to A and B (in the aggregate) annually for those first five years. During the subsequent five years, the REIT's 90% share of the $500 of annual book depreciation on Property X would be $450. Since there would be no tax depreciation on Property X during those years, the OP would make annual remedial allocations of $450 of ordinary deductions to the REIT and $450 of ordinary income to A and B (in the aggregate) in those years.

The maximum amount of the potential section 704(c) allocation of built-in gain if the contributed property were sold declines over the depreciable life of the property as the book-tax difference with respect to the property "burns off" and eventually reaches zero at the end of the depreciable life. As a result, contributors have the strongest incentive to use the traditional method if there are relatively few years remaining on the depreciable life of the property (i.e., so that no curative or remedial allocations would be made as a result of the ceiling rule problem). When UPREIT deals first became common in the mid-90s, REITs often failed to focus on section 704(c), presumably because REITs generally make dividends such that they receive sufficient dividends paid deductions so as to avoid corporate level tax.[30] However, over time, REITs have become very sensitive to the impact of the different section 704(c) methods. A number of operating partnerships now use the "traditional method with a curative allocation upon the sale of the property" to the extent that depreciation has previously been limited under the section 704(c) Regulations.[31]

III. CONCLUSION

UPREIT deals are often the most attractive option for a real estate owner that wishes to dispose of his real estate in a nonrecognition transaction in which he can achieve diversification of his holdings and be relieved of the burden of managing his real estate. As noted above, a section 1031 like-kind exchange can be tax-free, but generally does not result in diversification or an easy exit strategy. In contrast, an UPREIT deal enables a property contributor to diversify his holdings while also obtaining the ability to easily convert each of his operating partnership Units into one publicly traded REIT share without requiring any valuation. While both diversification and tax deferral can also be achieved by contributing real estate to a private equity fund (which is typically structured as a partnership), private equity funds generally seek quick profits and often have finite lives and, as a result, generally are loathe to accept the lockout period that is necessary in order for the contributor to avoid recognizing the deferred built-in gain under section 704(c). REITs, on the other hand, historically have generally been long-term holders of property and often are the only ones who might tolerate the lockout period. In addition, there may be state and local tax benefits from engaging in a transaction with a REIT. For example, New York State and New York City have a reduced real property transfer tax for certain transactions involving a REIT (including the operating partnership of an UPREIT).

While a Unit deal with an UPREIT may be the most desirable option for a real estate owner, this type of transaction requires intricate tax planning in order to avoid gain recognition both at the time of the transaction and in the years that follow. There are a number of useful techniques that can be employed for purposes of ensuring tax deferral in an UPREIT transaction, and countless pitfalls lie in wait to catch the unwary.

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[1] All section references are to the Internal Revenue Code of 1986, as amended, unless otherwise stated.

[2] *See* Treas. Reg. § 1.351-1(c). Under section 351(a), in general, no gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in the corporation and, immediately after the exchange, the person or persons have 80% of the vote and value of the corporation. However, section 351(e) provides that section 351 does not apply to a transfer of property to an "investment company," which is defined to include a REIT.

[3] Either way, this transaction generally would be treated for Federal income tax purposes as an "assets over" partnership merger of the property-owning partnership and the operating partnership of the REIT, with the operating partnership as the surviving entity. *See* Treas. Reg. § 1.708-1.

[4] I.R.C. § 707(a)(2)(B).

[5] *Id.*

[6] Treas. Reg. § 1.707-3(c)(1).

[7] Treas. Reg. § 1.707-4(d).

[8] A determination of whether the assumption of the liability is part of a disguised sale would then be made under the general disguised sale rules (i.e., based on all the facts and circumstances, with a rebuttable presumption of there being a disguised sale if the contribution of property and the assumption of the liability occur within two years of each other).

[9] Treas. Reg. § 1.707-5(a)(1).

[10] Treas. Reg. § 1.707-5(a)(5).

[11] Treas. Reg. § 1.707-5(a)(6)(i). If an assumed liability is a recourse liability, the amount of the liability which constitutes a qualified liability may not exceed the fair market value of the transferred property at the time of the transfer. Treas. Reg. § 1.707-5(a)(6)(ii).

[12] Treas. Reg. § 1.707-5(a)(6)(i)(A).

[13] Treas. Reg. § 1.707-5(a)(6)(i)(B). There is a presumption that, if within a two-year period a partner incurs a liability and transfers property to a partnership, and the partnership assumes or takes subject to the liability as part of the transfer, the liability was incurred in anticipation of the transfer unless "the facts and circumstances clearly establish that the liability was not incurred in anticipation of the transfer." Treas. Reg. § 1.707-5(a)(7)(i). This presumption would have to be rebutted in order for a liability to be considered to be a qualified liability under Regulation section 1.707-5(a)(6)(i)(B). Also, a disclosure is required if a liability is treated as a qualified liability under Regulation section 1.707-5(a)(6)(i)(B). Treas. Reg. § 1.707-5(a)(7)(ii).

[14] Treas. Reg. § 1.707-5(a)(6)(i)(C). Interesting questions arise with respect to capital contributions made to entities when interests in such entities are then contributed to a partnership.

[15] Treas. Reg. § 1.707-5(a)(6)(i)(D).

[16] Treas. Reg. § 1.707-5(a)(7)(i). In addition, the Regulations would impose a disclosure requirement. Treas. Reg. § 1.707-5(a)(7)(ii).

[17] The amount of partnership minimum gain is determined by first computing for each partnership nonrecourse liability any gain the partnership would realize if it disposed of the property subject to that liability for no consideration other than full satisfaction of the liability, and then aggregating the separately computed gains. Treas. Reg. § 1.704-2(d)(1). At the time of the contribution, the book value of the property will be equal to its fair market value, and no portion of the liability in question will be allocated under the first tier.

[18] Treas. Reg. § 1.752-3(a)(2).

[19] Treas. Reg. § 1.752-3(a)(3). The Regulations specify that the partnership agreement may specify the partners' interests in the partnership profits for purposes of allocating excess nonrecourse liabilities provided that the interests so specified are "reasonably consistent with allocations (that have substantial economic effect under the section 704(b) regulations) of some other significant item of partnership income or gain." *Id.*

[20] Treas. Reg. § 1.752-3(a)(3). This method of allocation of nonrecourse debt is not available when allocating debt for purposes of the disguised sale rules under section 707.
In addition, excess nonrecourse liabilities may also be allocated among the partners in accordance with the manner "in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated." Treas.

Reg. § 1.752-3(a)(3). If a partnership uses this method of liability allocation for purposes of section 752, the method apparently would apply for disguised sale purposes as well.

[21] Treas. Reg. § 1.752-2(b)(1); Treas. Reg. § 1.752-2(f), Example 5

[22] *See* NPRM REG-119305-11; Prop. Treas. Reg. § 1.752-2.

[23] See *Canal Corp. v. Commissioner*, 135 T.C. No. 9 (2010). Under Regulation section 1.752-2(k), in determining the extent to which a partner bears the economic risk of loss for a partnership liability, an obligation of a disregarded entity in general is taken into account only to the extent of the net value of the disregarded entity.

[24] For example, this could occur as a result of an amount of the operating partnership's liabilities being allocated to other partners under the "first tier" such that there would not be sufficient "second tier" and "third tier" liabilities allocated to the contributor to avoid a deemed distribution under section 752 that would trigger gain recognition.

[25] Treas. Reg. § 1.704-3.

[26] Treas. Reg. § 1.704-3(a)(2).

[27] Treas. Reg. § 1.704-3(b).

[28] This transaction would be treated for Federal income tax purposes as an "assets over" partnership merger of partnership AB and the OP, with the OP as the surviving entity. *See* Treas. Reg. § 1.708-1.

[29] Treas. Reg. § 1.704-3(d).

[30] *See* I.R.C. 857(b)(2)(B); 857(b)(3)(A)(ii).

[31] *See* Treas. Reg. § 1.704-3(c)(3)(iii)(B). In the above example, if the OP used the "traditional method with a curative allocation upon the sale of the property" and Property X were sold two years after it was contributed to the OP, the OP would make a $1,600 curative allocation upon the sale in order to offset the $800 amount of the ceiling rule limitation from each of those two years.