

# Real Estate Dequity Investments: Tax Choices and Consequences

by James Manzione



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In this report, Manzione explains the federal income tax aspects of real estate passthrough investments that could reasonably be treated as either debt or equity for federal income tax purposes.

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## I. Introduction

This report serves as a guide for tax lawyers advising clients on the federal income tax aspects of real estate passthrough<sup>1</sup> investments that could reasonably be treated as either debt or equity for federal income tax purposes. Rather than provide a comprehensive discussion of the features that would lead to an investment's treatment as either debt or equity, it assumes a "borderline" investment the commercial terms of which the parties are willing to adjust to ensure a tax-efficient result and focuses on the different tax consequences that follow depending on whether the investment is treated as debt or equity.<sup>2</sup>

## II. Basics of Dequity

### A. Typical Investment

Some investors in the real estate markets have realized excellent returns from investments that

<sup>1</sup>This report uses the term "passthrough" to refer to any entity that is either disregarded or treated as a partnership for federal income tax purposes.

<sup>2</sup>For a discussion of the features relevant to an investment's treatment as either debt or equity for federal income tax purposes in the passthrough context, see Steven R. Schneider, "Is Debt vs. Equity Different in a Partnership?" *Taxes — The Tax Magazine* (Mar. 2015); and J. William Dantzer Jr., "The Distinction Between Partnership Debt and Partnership Equity," *Tax Notes*, July 10, 2017, p. 197.

combine features of both mezzanine debt and participating preferred equity. These investments go by various names, but this report refers to them as “dequity investments” (and the investors who make them as “dequity investors”) for convenience. A simplified example of a typical dequity investment is a preferred interest issued for cash in a two-member<sup>3</sup> limited liability company that wholly owns, directly or indirectly, a single real estate property encumbered by senior financing. The LLC agreement typically contains a distribution waterfall similar to the following:

Net cash flow<sup>4</sup> shall be distributed in the following order of priority:

First, to the holder of the preferred interest until such holder has received a return of its capital contributions.

Second, to the holder of the preferred interest until such holder has received an internal rate of return on its capital contributions of 10 percent, compounded annually.

Third, to the holder of the common interest until such holder has received a return of its capital contributions.

Fourth, to the holder of the common interest until such holder has received an internal rate of return on its capital contributions of 10 percent, compounded annually.

Fifth, 80 percent to the holder of the common interest and 20 percent to the holder of the preferred interest.

For simplicity, this report refers to this distribution waterfall as the “base case waterfall” and the dequity investor’s entitlement to 20 percent of the proceeds distributed under its fifth prong as the “equity kicker.”

<sup>3</sup> A common investor typically contributes at least enough cash to the LLC for the property leverage ratio to be within the normal range for a real estate investment even when the dequity investment is treated as debt.

<sup>4</sup> The LLC agreement typically defines “net cash flow” as revenue generated by the property less expenses (including the expense of debt service payable to the senior lender), capital expenditures, and reserves.

## B. Choice

While terms similar to those described above represent the core of a dequity investment, the remaining terms of the investment are what tax lawyers typically focus on to determine the investment’s treatment for federal income tax purposes. As indicated, a substantial body of commentary exists that discusses which terms are relevant to this determination.<sup>5</sup> Most tax lawyers will insist on a maturity date as a minimum condition for debt treatment.<sup>6</sup> Some tax lawyers will suggest a cap on the equity kicker to ensure debt treatment.<sup>7</sup> Because the terms of the typical dequity investment require payment before maturity only to the extent of net cash flow from the property, there is often little possibility for a default to occur before maturity (and thus little opportunity before maturity for the dequity investor to exercise the traditional creditors’ rights widely regarded as a hallmark of debt treatment). Upon maturity, however, the dequity investor’s rights are similar to those of a typical nonrecourse creditor. In the context of a preferred interest in an LLC, maturity typically takes the form of a required redemption date for the preferred interest. If the underlying property has not been sold by the required redemption date, the dequity investor, under procedures set forth in the LLC agreement, typically has the right to exercise remedies akin to creditors’ rights by forcing a sale of the property to fund the redemption. That said, labels and the intended treatment of the instrument for nontax purposes matter.<sup>8</sup> A typical dequity investment is not labeled or treated as debt for certain nontax purposes (for example, by the senior lender) and thus could arguably be treated as equity even when the dequity investor has the rights

<sup>5</sup> See *supra* note 2.

<sup>6</sup> See, e.g., *Gilbert v. Commissioner*, 248 F.2d 399, 402 (2d Cir. 1957) (in which a debt instrument is defined, in part, as “an unqualified obligation to pay a sum certain at a reasonably close *fixed maturity date*”) (emphasis added).

<sup>7</sup> The examples in this report ignore the possibility of a cap on the equity kicker because the parties often set the cap at an amount that makes it unlikely to be operative.

<sup>8</sup> See, e.g., Notice 94-47, 1994-1 C.B. 357 (including the “label placed upon the instruments by the parties” and “whether the instruments are intended to be treated as debt or equity for non-tax purposes” as two factors on a list of eight relevant to determining the characterization of an instrument for federal income tax purposes).

mentioned earlier. If the parties want to ensure equity treatment and are confident that they will sell the property within a specific period, the equity investor may even be willing to forgo a maturity date. The point is that there is enough uncertainty in the law, and enough flexibility possessed by some of the parties that invest in this space, for choice to exist in how equity investments are taxed. To make the right choice, the parties must know what is at stake. The rest of this report explores just that.

### III. Treatment as Debt

#### A. Illustration of General Rules

To understand the taxation of a equity investment treated as debt for federal income tax purposes, consider the following example.

**Example 1:** Delaware LLC XYZ has the base case waterfall and purchases a single real estate property for \$100 million that it will hold for investment. Senior lender X funds \$60 million of the \$100 million in exchange for a conventional, non-amortizing mortgage note from XYZ bearing fixed interest at a rate of 5 percent per annum. Equity investor Y funds \$30 million of the \$100 million in exchange for the preferred interest in XYZ. Common investor Z funds \$10 million of the \$100 million in exchange for the common interest in XYZ. The XYZ LLC agreement provides that (1) Y's interest in XYZ will be treated as debt; (2) XYZ will be disregarded from Z for federal income tax purposes; and (3) in 10 years, if the property has not yet been sold and the sale proceeds distributed under the base case waterfall in liquidation of Y's interest in XYZ, Y will be entitled to force a sale of the property to fund a redemption of its interest in accordance with its entitlements under the base case waterfall. The XYZ LLC agreement also contains additional, primarily noneconomic features beyond the scope of this report designed to bolster the position that Y's interest should be treated as debt for federal income tax purposes.

If debt treatment for federal income tax purposes is respected, Y's interest in XYZ is

treated as a contingent payment debt instrument (CPDI) issued by Z<sup>9</sup> because payments to Y are contingent upon when and how much net cash flow is generated by the property owned by XYZ.<sup>10</sup> Because Y pays cash for its interest and no special exceptions apply, the noncontingent bond method described in the CPDI regulations must be used to determine the tax consequences related to Y's interest.<sup>11</sup> Under the noncontingent bond method, Z, as issuer of the instrument, must first determine the "comparable yield" of the instrument issued to Y by determining the yield at which Z would issue a fixed rate instrument with terms similar to the instrument actually issued by Z.<sup>12</sup> If the instrument is "marketed or sold in substantial part to persons for whom the inclusion of interest . . . is not expected to have a substantial effect on their U.S. tax liability," the comparable yield is presumed to be the applicable federal rate based on the overall maturity of the instrument.<sup>13</sup> This report assumes that the applicable federal rate presumption does not apply.

After determining the comparable yield, Z must construct a projected payment schedule for the instrument.<sup>14</sup> Given that each payment to Y is contingent on the amount and timing of net cash flow and that none of the payments to Y are based on "market information" (as defined in reg. section 1.1275-4(b)(4)(iii)), the projected payment schedule must consist entirely of Z's estimates of the timing and expected value of each payment.<sup>15</sup> Both the comparable yield and the projected payment schedule must be supported by contemporaneous documentation showing that both are reasonable, based on reliable, complete, and accurate data, and made in good faith.<sup>16</sup> If Z's initial projected payment schedule does not produce the comparable yield, Z must adjust the

<sup>9</sup> Z is the sole owner of XYZ for federal income tax purposes, causing XYZ to be disregarded from Z. See reg. section 301.7701-3. This report assumes that XYZ does not file an election to be treated as a corporation for federal income tax purposes.

<sup>10</sup> Reg. section 1.1275-4(a)(1). Note that none of the exceptions to CPDI treatment listed in reg. section 1.1275-4(a)(2) apply.

<sup>11</sup> Reg. section 1.1275-4(a)(1) and (b).

<sup>12</sup> Reg. section 1.1275-4(b)(3)(i) and (4)(i).

<sup>13</sup> Reg. section 1.1275-4(b)(4)(i)(B).

<sup>14</sup> Reg. section 1.1275-4(b)(3)(ii) and (4)(ii).

<sup>15</sup> Reg. section 1.1275-4(b)(4)(ii)(B).

<sup>16</sup> Reg. section 1.1275-4(b)(4).

Table 1

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
<b>Gross revenue</b>	\$10,000,000 rental revenue	\$10,500,000 rental revenue	\$11,025,000 rental revenue	\$11,576,250 rental revenue	\$12,155,063 rental revenue	\$12,762,816 rental revenue	\$13,400,956 rental revenue + \$150,000,000 sales proceeds
<b>Expenses (other than senior debt service)</b>	(\$5,000,000) property expenses	(\$5,150,000) property expenses	(\$5,304,500) property expenses	(\$5,463,635) property expenses	(\$5,627,544) property expenses	(\$5,796,370) property expenses	(\$5,970,261) property expenses
<b>Senior debt service</b>	(\$3,000,000) interest expense	(\$3,000,000) interest expense	(\$3,000,000) interest expense	(\$3,000,000) interest expense	(\$3,000,000) interest expense	(\$3,000,000) interest expense	(\$3,000,000) interest expense + (\$60,000,000) principal repayment
<b>Net cash flow</b>	\$2,000,000	\$2,350,000	\$2,720,500	\$3,112,615	\$3,527,519	\$3,966,446	\$94,430,695

projected payment schedule so that it does produce the comparable yield.<sup>17</sup> Z must provide Y with its projected payment schedule, and Y is required to use Z's projected payment schedule to determine interest accruals, provided Z's projected payment schedule is reasonable.<sup>18</sup>

Although there is little guidance concerning precisely how issuers should determine the comparable yield of an instrument with contingencies that are not based on market information, the CPDI regulations generally respect the determination of the issuer.<sup>19</sup> If Z can establish that another party would have been willing to offer a more conventional mezzanine loan of \$30 million to Z for the same property on a similarly subordinated basis bearing interest at, say, 12 percent, compounded annually, then it would seem that 12 percent, compounded annually, is a reasonable choice for a comparable yield.<sup>20</sup> For purposes of Example 1, this report

assumes a comparable yield of 12 percent, compounded annually.

To construct a projected payment schedule, Z should look to its internal projections regarding the property's net cash flow. Assume Z expects XYZ to receive gross rental revenue of \$10 million in year 1, which will increase by 5 percent per year; pay property expenses of \$5 million in year 1, which will increase by 3 percent per year; service the senior debt; and sell the property at the end of year 7 for \$150 million. Z thus projects the statement of cash flows shown in Table 1.

This report assumes that the parties expect the total amount of net cash flow for each year to be distributed at the end of that year.<sup>21</sup> Because, under the base case waterfall, Y must receive its \$30 million plus a 10 percent internal rate of return (IRR) before Z receives anything, Y receives, if the above projections are accurate, all the net cash flow generated in years 1 through 6. Y also receives the first \$34,400,793 distributed in year 7.<sup>22</sup> Z receives the next \$19,497,351 distributed in year 7.<sup>23</sup> Of the remaining

<sup>17</sup> Reg. section 1.1275-4(b)(4)(ii)(C).

<sup>18</sup> See reg. section 1.1275-4(b)(4)(iv).

<sup>19</sup> Reg. section 1.1275-4(b)(v).

<sup>20</sup> Although reg. section 1.1275-4(b)(4)(i)(A) provides that the "riskiness of the contingencies" should not be taken into account in determining the comparable yield, the value of the contingencies presumably should be taken into account. It thus seems logical that a comparable fixed rate debt instrument would have a higher yield than the 10 percent that is payable "currently" to Y.

<sup>21</sup> This is not a realistic assumption, but it simplifies some of the calculations in this report without materially changing the analysis.

<sup>22</sup> Calculated using the Goal Seek and XIRR functions in Microsoft Excel.

<sup>23</sup> Calculated in the same manner described in *supra* note 22.

Table 2

Jan. 1, 2023	Jan. 1, 2024	Jan. 1, 2025	Jan. 1, 2026	Jan. 1, 2027	Jan. 1, 2028	Jan. 1, 2029	Jan. 1, 2030
(\$30,000,000)	\$2,000,000	\$2,350,000	\$2,720,500	\$3,112,615	\$3,527,519	\$3,966,446	\$42,507,303

Table 3

Jan. 1, 2023	Jan. 1, 2024	Jan. 1, 2025	Jan. 1, 2026	Jan. 1, 2027	Jan. 1, 2028	Jan. 1, 2029	Jan. 1, 2030
(\$30,000,000)	\$2,000,000	\$2,350,000	\$2,720,500	\$3,112,615	\$3,527,519	\$3,966,446	\$40,710,196

\$40,532,551,<sup>24</sup> Z receives 80 percent (\$32,426,041), and Y receives 20 percent (\$8,106,510) under the last prong of the base case waterfall. As a result, Z should construct the initial projected payment schedule as shown in Table 2.<sup>25</sup>

But this projected payment schedule does not produce the comparable yield of 12 percent, compounded annually.<sup>26</sup> As a result, under reg. section 1.1275-4(b)(4)(ii)(C), Z must adjust the initial projected payment schedule so that it produces the comparable yield. The regulations are unclear on exactly how to do this, but, given that the final payment contains the equity kicker, which is presumably the least certain of the payments, it seems sensible for Z simply to reduce the final projected payment so that the projected payment schedule produces the comparable yield of 12 percent, compounded annually. Assume Z takes this approach and revises the projected payment schedule as shown in Table 3.

Interest accrues for each accrual period (which, for simplicity, this report assumes is one year) by multiplying the adjusted issue price of

the instrument by the comparable yield of 12 percent.<sup>27</sup> The adjusted issue price is \$30 million at the beginning of year 1. Under reg. section 1.1275-4(b)(7)(ii), it increases at the end of each accrual period by previously accrued interest (ignoring the adjustments discussed below) and decreases at the end of each accrual period by previously scheduled payments. Table 4 illustrates the adjusted issue price and interest accruals over the life of Y's instrument.

Table 4

Accrual Period	Projected Payment Schedule	Adjusted Issue Price (Beginning of Period)	Interest Accrued During Period
1	\$2,000,000	\$30,000,000	\$3,600,000
2	\$2,350,000	\$31,600,000	\$3,792,000
3	\$2,720,500	\$33,042,000	\$3,965,040
4	\$3,112,615	\$34,286,540	\$4,114,385
5	\$3,527,519	\$35,288,310	\$4,234,597
6	\$3,966,446	\$35,995,388	\$4,319,447
7	\$40,710,196	\$36,348,389	\$4,361,807

## B. Adjustments and Exchanges

Of course, actual payments will almost certainly differ from projected payments. When this happens, the CPDI regulations require Y and Z to take the difference into account as a positive adjustment (when the actual payment exceeds the projected payment) or as a negative adjustment (when the projected payment exceeds the actual

<sup>24</sup>\$94,430,695 minus \$34,400,793 minus \$19,497,351.

<sup>25</sup>Note that Z's projected payment schedule covers the seven years that the parties expect the instrument to be outstanding rather than the 10 years that it could be outstanding. Though this seems like the only rational way to construct the projected payment schedule, the CPDI regulations generally reserve on timing contingencies, and several commentators have pointed out various uncertainties applying the noncontingent bond method to instruments involving timing contingencies. See reg. section 1.1275-4(b)(9)(iii)(B); Paul Kunkel, Ivan Thomann, and Liz Dyor, "Accruing Original Issue Discount on Excess Cash Flow Sweep Loans," 11 *J. Tax'n Fin. Prod.* 3 (2013); Sara B. Zablottney, "Debt Instruments Subject to Timing Contingencies: A Discussion and Proposal," Bloomberg BNA *Tax Management Memorandum* (Aug. 2013); and New York State Bar Association Tax Section, "Report on Ambiguities and Uncertainties in the Original Issue Discount Regulations," Report No. 1212 (2010).

<sup>26</sup>The yield is about 12.52 percent, calculated using the XIRR function in Microsoft Excel.

<sup>27</sup>Reg. section 1.1275-4(b)(3)(iii).

payment).<sup>28</sup> These adjustments have no effect on the instrument's adjusted issue price (and therefore future accruals) or adjusted basis.<sup>29</sup>

A net positive adjustment for a tax year is treated as additional interest paid/received in that tax year.<sup>30</sup> If, for example, Y actually receives the initially projected \$42,507,303 (rather than \$40,710,196) in year 7, both Y and Z would take into account a positive adjustment of \$1,797,107, which would generate, in year 7, \$1,797,107 in additional interest income for Y and, assuming no interest deduction limitations applied, a \$1,797,107 additional interest deduction for Z.

A net negative adjustment for a tax year is treated as follows: (1) as a reduction of interest that otherwise would have been treated as paid/received in the year of the adjustment; (2) if the net negative adjustment exceeds the interest that otherwise would have been treated as paid/received in the year of the adjustment, as ordinary loss to Y to the extent of the excess of Y's interest inclusions from the instrument over Y's net negative adjustments treated as ordinary loss in prior years and as ordinary income to Z to the extent of the excess of Z's interest deductions from the instrument over Z's net negative adjustments treated as ordinary income in prior years; and (3) to the extent of any remaining net negative adjustment, as a negative adjustment carryforward that, if unused before the sale, exchange, or retirement of the instrument, is treated by Y as a reduction in amount realized and by Z as ordinary income.<sup>31</sup>

Any gain recognized by Y on the sale, exchange, or retirement of the instrument is treated as interest income.<sup>32</sup> Any loss recognized by Y on the sale, exchange, or retirement of the instrument is treated as ordinary loss to the extent Y's prior interest inclusions on the instrument exceed Y's prior net negative adjustments taken into account as ordinary loss. Any remaining loss

is treated as capital loss assuming Y held the instrument as a capital asset.<sup>33</sup>

For an instrument held as a capital asset, the CPDI rules ensure that any net economic gain over the life of the instrument is ordinary income and that any net economic loss over the life of the instrument is capital loss.<sup>34</sup> Some have called this "worst of both worlds" taxation.<sup>35</sup>

## IV. Treatment as Equity

### A. Illustration of General Rules

To understand the taxation of a dequity investment treated as equity for federal income tax purposes, consider the following example.

**Example 2:** Delaware LLC XYZ has the base case waterfall and purchases a single real estate property for \$100 million that it will hold for investment. Senior lender X funds \$60 million of the \$100 million in exchange for a conventional, non-amortizing mortgage note from XYZ bearing fixed interest at a rate of 5 percent per annum. Dequity investor Y funds \$30 million of the \$100 million in exchange for the preferred interest in XYZ. Common investor Z funds \$10 million of the \$100 million in exchange for the common interest in XYZ. The XYZ LLC agreement provides that (1) Y's interest will be treated as equity for federal income tax purposes; (2) XYZ will be treated as a partnership for federal income tax purposes (with Y and Z treated as partners in XYZ); and (3) net income and net loss of XYZ will be allocated among the members of XYZ so that the capital account of each member immediately after making that allocation is, as nearly as possible, equal to (A) the distributions that would be made to that member if XYZ's assets were sold for cash equal to their book values, all XYZ liabilities were satisfied (limited, for each nonrecourse liability, to the book values of the assets securing that liability), and the net cash of XYZ was distributed to the members in accordance with the base case waterfall minus (B) any amount that member is

<sup>28</sup> Reg. section 1.1275-4(b)(6).

<sup>29</sup> Reg. section 1.1275-4(b)(7)(ii) and (iii). For an explanation of the logic of this approach, see Paul H. Asofsky, "A Guide to the Tax Treatment of Contingent Payment Debt Instruments," in NYU 56th Institute on Federal Taxation, ch. 5 (1998).

<sup>30</sup> Reg. section 1.1275-4(b)(6)(ii).

<sup>31</sup> Reg. section 1.1275-4(b)(6)(iii).

<sup>32</sup> Reg. section 1.1275-4(b)(8)(i).

<sup>33</sup> Reg. section 1.1275-4(b)(8)(ii).

<sup>34</sup> Special rules irrelevant here can change this result when there are no remaining contingencies at the time of the sale, exchange, or retirement of the instrument. See reg. section 1.1275-4(b)(8)(iii).

<sup>35</sup> See, e.g., Jeffrey Maddrey, "Time Value of Money — Holders of Debt Instruments," Bloomberg Tax (Portfolio 181) at V.C.6.

Table 5

Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
(\$500,000)	(\$150,000)	\$220,500	\$612,615	\$1,027,519	\$1,466,446	\$69,430,695

obligated to return to XYZ, that member's share of "partnership minimum gain," and that member's share of "partner nonrecourse debt minimum gain" (each as defined in the regulations and computed immediately before that hypothetical sale of assets).<sup>36</sup> The XYZ LLC agreement also contains standard partnership tax boilerplate language.<sup>37</sup>

If equity treatment for federal income tax purposes is respected, XYZ allocates to each of Y and Z a distributive share of its income, gain, loss, deduction, and credit as determined under the allocation provisions in the XYZ LLC agreement.<sup>38</sup> Assuming the results initially projected in Example 1, and assuming depreciation of \$2.5 million per year, XYZ has the amounts of net income and net loss for each year as shown in Table 5.<sup>39</sup>

Under the target allocation provision, as a result of Z's subordination to Y, XYZ allocates the net loss in years 1 and 2 entirely to Z and the net income in years 3 through 6 entirely to Y. Under the base case waterfall, XYZ makes distributions identical to those described in Example 1. As a

result, Y and Z have the following capital accounts at the beginning of year 7<sup>40</sup>:

Y Capital Account	Z Capital Account
\$15,650,000	\$9,350,000

At the end of year 7, after XYZ sells the property and pays off the senior debt, XYZ has \$94,430,695 of cash, of which Y will receive \$42,507,303 and Z will receive \$51,923,392, calculated as described in Example 1. Therefore, under the target allocation provision, XYZ allocates the \$69,430,695 of year 7 income as \$26,857,303 to Y and \$42,573,392 to Z.

To summarize, on the facts of Example 2, XYZ allocates its net income and net loss over its life as shown in Table 6.

Table 6

Year	Y	Z
1	—	(\$500,000)
2	—	(\$150,000)
3	\$220,500	—
4	\$612,615	—
5	\$1,027,519	—
6	\$1,466,446	—
7	\$26,857,303	\$42,573,392

Assuming full deductibility of expenses (including interest on the senior debt) and that Y and Z are subject to federal income tax, the above shows the overall amounts that each of Y and Z include from XYZ in determining its taxable income. The income and loss in years 1 through 6

<sup>36</sup> Practitioners refer to clause (3) as a "target allocation" provision. This report assumes general familiarity with target allocation provisions. For more explanation and analysis, see Todd D. Golub, "Target Allocations: The Swiss Army Knife of Drafting (Good for Most Situations — But Don't Bet Your Life on It)," *87 Taxes* 157 (2009); NYSBA Tax Section, "Report on Partnership Target Allocations," Report No. 1219 (2010); William G. Cavanagh, "Targeted Allocations Hit the Spot," *Tax Notes*, Oct. 4, 2010, p. 89; Daniel S. Goldberg, "The Target Method for Partnership Special Allocations and Why It Should Be Safe Harbored," *69 Tax Law* 663 (2016); and James Manzione, "Real Estate Partnerships: The Basics and Some Technical Stuff," *Tax Notes Federal*, Nov. 23, 2020, p. 1237.

<sup>37</sup> For an explanation of standard partnership tax boilerplate language, see Ivan Mitev and Matt Kaden, *Drafting Partnership and LLC Agreements: Tax Boilerplate, Allocation, and Liquidation Provisions* (2010).

<sup>38</sup> See section 704. This report assumes that all XYZ allocations are respected.

<sup>39</sup> These amounts are calculated for years 1 through 6 by subtracting the \$2.5 million of depreciation from the amounts shown in Example 1 as net cash flow. For year 7, net income is calculated by adding the \$13,400,956 rental revenue to the \$67.5 million income from the sale of the property (\$150 million minus the property's \$82.5 million adjusted basis) and subtracting the \$5,970,261 of property expenses, \$3 million of senior debt interest, and \$2.5 million of depreciation.

<sup>40</sup> For Y, this amount represents its initial capital account of \$30 million minus its distributions of \$2 million, \$2.35 million, \$2,720,500, \$3,112,615, \$3,527,519, and \$3,966,446 in each of years 1 through 6, respectively, plus its net income allocations of \$220,500, \$612,615, \$1,027,519, and \$1,466,446 in each of years 3 through 6, respectively. For Z, this amount represents its initial capital account of \$10 million minus its net loss allocations of \$500,000 and \$150,000 in years 1 and 2, respectively.

are ordinary (composed of rent, business expenses, interest, and depreciation). In year 7, \$67.5 million of the income is section 1231 gain from the sale of the property treated as long-term capital gain (of which \$17.5 million is unrecaptured section 1250 gain as a result of seven years of \$2.5 million depreciation per year). The rest of the income in year 7 is ordinary. For purposes of Example 2, assume that XYZ allocates its various items in year 7 pro rata according to Y and Z's overall share of net income in year 7. That is, assume that XYZ allocates to Y in year 7 \$746,835 of the ordinary income, \$6,769,381 of the unrecaptured section 1250 gain, and \$19,341,088 of the remaining section 1231 gain; and that XYZ allocates to Z in year 7 \$1,183,860 of the ordinary income, \$10,730,619 of the unrecaptured section 1250 gain, and \$30,658,912 of the remaining section 1231 gain.

## B. Illustration Using Gross Allocations

Although many LLC agreements permit the allocation of only net income and net loss as in Example 2, some limited liability agreements permit, and the law in some scenarios arguably requires, the use of gross allocations if net allocations are insufficient to bring the capital accounts in line with their target balances.<sup>41</sup> To understand how the results would differ if XYZ used gross allocations, consider the following example.

**Example 3:** Assume the same facts as Example 2 except that the target allocation provides for the allocation of gross items of income and loss to the extent necessary to bring the members' capital accounts in line with their target balances. As a result, for the first three years, XYZ allocates its income and loss as shown in Table 7.<sup>42</sup>

**Table 7**

Year	Y	Z
1	\$3,000,000	(\$3,500,000)
2	\$3,100,000	(\$3,250,000)
3	\$3,175,000	(\$2,954,500)

At the beginning of year 4, Y and Z have the following capital accounts<sup>43</sup>:

Y Capital Account	Z Capital Account
\$32,204,500	\$295,500

Part of the partnership tax boilerplate language mentioned in Example 2 is a provision, referred to as a "loss limitation" provision, that requires XYZ to allocate loss that would otherwise be allocated to one member to the other member to the extent the loss allocation to the first member would create a deficit in the first member's capital account over the amount that member would be obligated to contribute to XYZ (plus its share of partnership minimum gain and partner nonrecourse debt minimum gain). Without the loss limitation provision, in year 4 XYZ would allocate to Y income of \$3,220,450 and to Z loss of \$2,607,835.<sup>44</sup> As a result of the loss limitation provision, however, in year 4 XYZ can allocate to Z a loss of only \$295,500 and thus allocates to Y the \$908,115 net balance.<sup>45</sup> Because Z can no longer receive allocations of loss and should not receive allocations of income, years 5 and 6 are identical to Example 2, with XYZ allocating to Y net income of \$1,027,519 and \$1,466,446, respectively. As a

<sup>41</sup>For a discussion of this topic, see NYSBA Tax Section, "Report on Guaranteed Payments and Preferred Returns," Report No. 1357 (2016); and Golub, *supra* note 36.

<sup>42</sup>Y has a target balance of \$33 million at the end of year 1, requiring a \$3 million allocation. After receiving a distribution of \$2 million at the end of year 1, Y's initial year 2 capital account is \$31 million. At the end of year 2, Y's target balance grows to \$34.1 million, requiring a \$3.1 million allocation. After receiving a distribution of \$2.35 million at the end of year 2, Y's initial year 3 capital account is \$31.75 million. At the end of year 3, Y's target balance grows to \$34,925,000, requiring a \$3,175,000 allocation. After making these gross allocations, XYZ allocates the balance of its items of profit and loss to Z.

<sup>43</sup>For Y, this amount represents its initial capital account of \$30 million minus its distributions of \$2 million, \$2.35 million, and \$2,720,500 in each of years 1 through 3, respectively, plus its income allocations of \$3 million, \$3.1 million, and \$3,175,000 in each of years 1 through 3, respectively. For Z, this amount represents its initial capital account of \$10 million minus its loss allocations of \$3.5 million, \$3.25 million, and \$2,954,500 in each of years 1 through 3, respectively.

<sup>44</sup>Calculated in the same manner described in *supra* note 42.

<sup>45</sup>These allocations implicitly assume that the loss limitation provision supersedes the requirement to bring Y's capital account in line with its target balance.



result, Y and Z have the following capital accounts at the beginning of year 7<sup>46</sup>:

Y Capital Account	Z Capital Account
\$25,000,000	\$0

XYZ distributes the \$94,430,695 of cash on hand at the end of year 7 in the same manner as in the previous examples: \$42,507,303 to Y and \$51,923,392 to Z. Therefore, under the target allocation provision, in year 7 XYZ allocates \$17,507,303 to Y and \$51,923,392 to Z.

To summarize, on the facts of Example 3, XYZ allocates its income and loss over its life as shown in Table 8.

**Table 8**

Year	Y	Z
1	\$3,000,000	(\$3,500,000)
2	\$3,100,000	(\$3,250,000)
3	\$3,175,000	(\$2,954,500)
4	\$908,115	(\$295,500)
5	\$1,027,519	—
6	\$1,466,446	—
7	\$17,507,303	\$51,923,392

As in Example 2, all income and loss in years 1 through 6 are ordinary. In year 7, \$67.5 million of the income is section 1231 gain from the sale of the property treated as long-term capital gain (of which \$17.5 million is unrecaptured section 1250 gain). The rest of the income in year 7 is ordinary. Assuming the same method for allocating the various types of items in year 7 as in Example 2, in year 7 XYZ allocates to Y \$486,835 of the ordinary income, \$4,412,714 of the unrecaptured section 1250 gain, and \$12,607,754 of the remaining section 1231 gain; and XYZ allocates to Z \$1,443,860 of the ordinary income, \$13,087,286 of the unrecaptured section 1250 gain, and \$37,392,246 of the remaining section 1231 gain.

<sup>46</sup> For Y, this amount represents its initial year 4 capital account of \$32,204,500 minus its distributions of \$3,112,615, \$3,527,519, and \$3,966,446 in each of years 4 through 6, respectively, plus its income allocations of \$908,115, \$1,027,519, and \$1,466,446 in each of years 4 through 6, respectively. For Z, this amount represents its initial year 4 capital account of \$295,500 minus its year 4 loss allocation of \$295,500.

## V. Separate Treatment

### A. What Is Separate Treatment?

A third option exists if the parties desire to treat a debt investment as other than entirely debt or entirely equity for federal income tax purposes: The debt investment could be separated into two instruments, with the first instrument entitling the debt investor to the distributions specified in the first and second prongs of the base case waterfall and the second instrument entitling the debt investor only to the equity kicker. The first instrument, which this report will refer to as the “debt piece,” is treated as debt for federal income tax purposes, and the equity kicker is treated as equity for federal income tax purposes. For that treatment to be respected, the debt piece and equity kicker must represent separate investments<sup>47</sup> and must be separately transferable.<sup>48</sup> The LLC agreement, or another document prepared by the issuer, specifies the amount paid for each instrument, and this amount determines the issue price of the debt piece and the initial capital account attributable to the equity kicker.<sup>49</sup>

### B. Illustration

To understand the taxation of a debt investment with separate debt and equity components, consider the following example.

**Example 4:** Delaware LLC XYZ has the base case waterfall (except the words “equity kicker interest” replace the words “preferred interest” in the fifth prong of the base case waterfall) and purchases a single real estate property for \$100 million that it will hold for investment. Senior lender X funds \$60 million of the \$100 million in exchange for a conventional, non-amortizing

<sup>47</sup> This is typically accomplished by creating separate LLC interests for each.

<sup>48</sup> See, e.g., Rev. Rul. 88-31, 1988-1 C.B. 302; and Rev. Rul. 2003-97, 2003-2 C.B. 380.

<sup>49</sup> Under reg. section 1.1273-2(h), which covers investment units consisting of debt and other property rights issued together, the issuer must make the allocation based on the instruments’ respective fair market values, and the issuer’s allocation generally binds all holders. While it is debatable whether an investment unit exists (and therefore whether this rule applies) when there is a separate holder of the debt piece and the equity kicker at initial issuance (as is the case in Example 4 below), most practitioners nonetheless follow the principles of reg. section 1.1273-2(h) in the context of a debt investment consisting of separate instruments.

Table 9

Jan. 1, 2023	Jan. 1, 2024	Jan. 1, 2025	Jan. 1, 2026	Jan. 1, 2027	Jan. 1, 2028	Jan. 1, 2029	Jan. 1, 2030
(\$27,145,947)	\$2,000,000	\$2,350,000	\$2,720,500	\$3,112,615	\$3,527,519	\$3,966,446	\$34,400,793

mortgage note from XYZ bearing fixed interest at a rate of 5 percent per annum. Dequity investor Y1 funds \$27,145,947<sup>50</sup> in exchange for the debt piece preferred interest in XYZ, and dequity investor Y2 funds \$2,854,053 in exchange for the equity kicker interest in XYZ.<sup>51</sup> Common investor Z funds \$10 million of the \$100 million in exchange for the common interest in XYZ. The XYZ LLC agreement provides that (1) Y1's interest in XYZ will be treated as debt for federal income tax purposes; (2) in 10 years, if the property has not yet been sold and the sale proceeds distributed under the base case waterfall in liquidation of Y1's interest in XYZ, Y1 will be entitled to force a sale of the property to fund a redemption of its interest in accordance with its entitlements under the base case waterfall; (3) Y2's interest will be treated as equity for federal income tax purposes; (4) XYZ will be treated as a partnership for federal income tax purposes (with Y2 and Z treated as partners in XYZ for federal income tax purposes); (5) net income and net loss of XYZ will be allocated among the members of XYZ so that the capital account of each member immediately after making that allocation is, as nearly as possible, equal to (A) the distributions that would be made to that member if XYZ's assets were sold for cash equal to their book values, all XYZ liabilities (including Y1's interest) were satisfied (limited, for each nonrecourse liability (including Y1's interest), to the book values of the assets securing that liability), and the net cash of XYZ was distributed to the members in accordance with the base case waterfall minus (B) any amount that member is obligated to return to XYZ, that member's share of "partnership minimum gain," and that member's share of "partner nonrecourse debt minimum gain" (each as defined in the regulations and computed immediately before that

hypothetical sale of assets); and (6) Y1 is not treated as a member for purposes of the target allocation provision and does not have a capital account. The XYZ LLC agreement also contains standard partnership tax boilerplate language and additional, primarily noneconomic features beyond the scope of this report designed to bolster the position that Y1's interest should be treated as debt for federal income tax purposes.

Although the law is unclear on this point, this report assumes that Y1's interest is a CPDI subject to the noncontingent bond method.<sup>52</sup> As a result, XYZ<sup>53</sup> determines a comparable yield (this report assumes the same 12 percent, compounded annually, used in Example 1) and constructs the Table 9 projected payment schedule based on the same projections used in Example 1.

The projected payment schedule produces the comparable yield of 12 percent, so XYZ does not need to make any adjustments to it. Using the same one-year accrual period assumption as in Example 1, Table 10 illustrates the adjusted issue price and interest accruals over the life of Y1's instrument.

Table 10

Accrual Period	Projected Payment Schedule	Adjusted Issue Price (Beginning of Period)	Interest Accrued During Period
1	\$2,000,000	\$27,145,947	\$3,257,514
2	\$2,350,000	\$28,403,461	\$3,408,415
3	\$2,720,500	\$29,461,876	\$3,535,425
4	\$3,112,615	\$30,276,801	\$3,633,216
5	\$3,527,519	\$30,797,402	\$3,695,688
6	\$3,966,446	\$30,965,571	\$3,715,869
7	\$34,400,793	\$30,714,994	\$3,685,799

<sup>50</sup> But the XYZ LLC agreement provides that Y1 is treated as having contributed \$30 million for purposes of determining distributions under the first and second prongs of the base case waterfall.

<sup>51</sup> This is a (useful) fiction. In the real world, Y would have \$30 million to invest in return for both the debt piece and the equity kicker, Y1 and Y2 would be affiliates of Y, and the tax lawyers and accountants would guide Y in determining how to allocate the \$30 million between the debt piece and equity kicker based on their respective FMVs.

<sup>52</sup> The commentary cited *supra* note 25 discusses the uncertainties in this area in depth.

<sup>53</sup> Unlike in Example 1, XYZ is the issuer because XYZ is a regarded entity for federal income tax purposes.

**Table 11**

Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
(\$3,757,514)	(\$3,558,415)	(\$3,314,925)	(\$3,020,601)	(\$2,668,169)	(\$2,249,423)	\$65,744,896

Assume for purposes of Example 4 that actual payments exactly match projected payments. After subtracting the above interest accruals from the net income and net loss amounts described in Example 2, XYZ has the amounts of net income and net loss for each year as shown in Table 11.

Under the target allocation provision, as a result of Y2's subordination to Z, XYZ allocates the first \$2,854,053 of year 1 net loss to Y2, bringing its capital account to zero, and the remaining \$903,461 of year 1 net loss to Z. XYZ then allocates all the \$3,558,415 year 2 net loss and all the \$3,314,925 year 3 net loss to Z, bringing its capital account to \$2,223,199 at the start of year 4. In year 4, XYZ allocates the first \$2,223,199 of year 4 net loss to Z, bringing its capital account to zero. At this point, each of Y2 and Z has a zero balance in its capital account. Yet XYZ must allocate the remaining \$797,402 of year 4 net loss, and all the year 5 net loss and year 6 net loss, somewhere. Although a full explanation of why is beyond the scope of this report, those losses should be treated as partner nonrecourse deductions and allocated entirely to Y2 under reg. section 1.704-2(i).<sup>54</sup> As a result, Y2 and Z have the following capital accounts at the beginning of year 7:

Y2 Capital Account	Z Capital Account
(\$5,714,994)	\$0

Because XYZ would distribute the \$60,029,902 of year 7 net cash flow \$8,106,510 to Y2 and \$51,923,392 to Z, XYZ allocates the \$65,744,896 of

year 7 income \$13,821,504 to Y and \$51,923,392 to Z.<sup>55</sup>

To summarize, on the facts of Example 4, XYZ allocates its income and loss over its life as shown in Table 12.

**Table 12**

Year	Y2	Z
1	(\$2,854,053)	(\$903,461)
2	—	(\$3,558,415)
3	—	(\$3,314,925)
4	(\$797,402)	(\$2,223,199)
5	(\$2,668,169)	—
6	(\$2,249,423)	—
7	\$13,821,504	\$51,923,392

As in the prior examples, all the losses in years 1 through 6 are ordinary. Here, however, because the interest deductions attributable to the liability owed to Y1 result in the year 7 ordinary deductions exceeding the year 7 ordinary income by \$1,755,104, all the year 7 income is section 1231 gain from the sale of the property treated as long-term capital gain (of which \$17.5 million is treated as unrecaptured section 1250 gain). Assuming XYZ uses the same approach to allocate its various items as in the prior examples, in year 7 XYZ allocates to Y2 \$368,974 of the ordinary loss, \$3,679,013 of the unrecaptured section 1250 gain, and \$10,511,465 of the remaining section 1231 gain; and XYZ allocates to Z \$1,386,130 of the ordinary loss, \$13,820,987 of the unrecaptured section 1250 gain, and \$39,488,535 of the remaining section 1231 gain.

<sup>54</sup> At the start of year 4, XYZ has property with a \$92.5 million adjusted basis (\$100 million initial basis minus three years of \$2.5 million depreciation) subject to two liabilities: a senior liability owed to X with an adjusted issue price of \$60 million and a junior liability owed to Y1 with an adjusted issue price of \$30,276,801. During year 4, further depreciation reduces the adjusted basis of the property to \$90 million, and further interest accruals increase the adjusted issue price of the junior liability owed to Y1 to \$30,797,402. Under reg. section 1.704-2(d)(2)(ii), no portion of the property's adjusted basis is allocated to the last \$797,402 of the junior liability owed to Y1. Because Y1 and Y2 are affiliates, the result is a partner nonrecourse deduction that must be allocated to Y2. See reg. section 1.704-2(m), Example 1(viii). A similar analysis applies regarding the year 5 and year 6 losses.

<sup>55</sup> Technically, XYZ allocates the first \$5,714,994 under a provision in the partnership tax boilerplate language called a partner nonrecourse debt minimum gain chargeback and the remainder under the target allocation provision.

Table 13

Year	Debt Treatment		Equity Treatment		Separate Treatment		
	Y	Z	Y	Z	Y1	Y2	Z
1	\$3,600,000	(\$4,100,000)	—	(\$500,000)	\$3,257,514	(\$2,854,053)	(\$903,461)
2	\$3,792,000	(\$3,942,000)	—	(\$150,000)	\$3,408,415	—	(\$3,558,415)
3	\$3,965,040	(\$3,744,540)	\$220,500	—	\$3,535,425	—	(\$3,314,925)
4	\$4,114,385	(\$3,501,770)	\$612,615	—	\$3,633,216	(\$797,402)	(\$2,223,199)
5	\$4,234,597	(\$3,207,078)	\$1,027,519	—	\$3,695,688	(\$2,668,169)	—
6	\$4,319,447	(\$2,853,001)	\$1,466,446	—	\$3,715,869	(\$2,249,423)	—
7	\$6,158,914	\$63,271,781	\$26,857,303	\$42,573,392	\$3,685,799	\$13,821,504	\$51,923,392

Table 14

Year	Debt Treatment		Equity Treatment		Separate Treatment		
	Y	Z	Y	Z	Y1	Y2	Z
1	\$1,332,000	(\$1,517,000)	—	(\$185,000)	\$1,205,280	(\$1,056,000)	(\$334,281)
2	\$1,403,040	(\$1,458,540)	—	(\$55,500)	\$1,261,114	—	(\$1,316,614)
3	\$1,467,065	(\$1,385,480)	\$81,585	—	\$1,308,107	—	(\$1,226,522)
4	\$1,522,322	(\$1,295,655)	\$226,668	—	\$1,344,290	(\$295,039)	(\$822,584)
5	\$1,566,801	(\$1,186,619)	\$380,182	—	\$1,367,405	(\$987,223)	—
6	\$1,598,195	(\$1,055,610)	\$542,585	—	\$1,374,872	(\$832,287)	—
7	\$2,278,798	\$12,810,559	\$5,836,892	\$9,252,465	\$1,363,746	\$2,885,526	\$10,840,086

## VI. Overview of the Stakes

### A. General Comparison

Table 13 summarizes the income and loss results in each of the different tax treatment scenarios discussed earlier (assuming the initially projected cash flows and assuming net income allocations when relevant).

Each of the scenarios above results in the same amount of overall income (\$30,184,383 for Y (Y1 and Y2 in the last scenario) and \$41,923,392 for Z), but each has significant timing and character differences (and therefore significant after-tax economic differences). Assuming a tax rate of 37

percent<sup>56</sup> for ordinary income, 25 percent for unrecaptured section 1250 gain, and 20 percent for any remaining section 1231 gain, and assuming full deductibility and the use of ordinary losses against ordinary income, Table 14 summarizes the taxes payable in each of the scenarios (with tax benefits shown in parentheses).

Table 15 summarizes the after-tax cash flows and IRR in each of the scenarios (with tax benefits shown as positive cash flows and Y1 and Y2 combined).

<sup>56</sup> This report ignores section 199A, which is scheduled to expire after 2025 and is subject to various limitations. The applicability of section 199A would reduce the effective tax rate on some of the ordinary income.

Table 15

Year	Debt Treatment		Equity Treatment		Separate Treatment	
	Y	Z	Y	Z	Y	Z
0	(\$30,000,000)	(\$10,000,000)	(\$30,000,000)	(\$10,000,000)	(\$30,000,000)	(\$10,000,000)
1	\$668,000	\$1,517,000	\$2,000,000	\$185,000	\$1,850,720	\$334,281
2	\$946,960	\$1,458,540	\$2,350,000	\$55,500	\$1,088,886	\$1,316,614
3	\$1,253,435	\$1,385,480	\$2,638,915	\$0	\$1,412,393	\$1,226,522
4	\$1,590,293	\$1,295,655	\$2,885,947	\$0	\$2,063,364	\$822,584
5	\$1,960,718	\$1,186,619	\$3,147,337	\$0	\$3,147,337	\$0
6	\$2,368,251	\$1,055,610	\$3,423,861	\$0	\$3,423,861	\$0
7	\$40,228,505	\$39,112,833	\$36,670,411	\$42,670,927	\$38,258,031	\$41,083,306
Economic profit	\$19,016,162	\$37,011,737	\$23,116,471	\$32,911,427	\$21,244,592	\$34,783,307
IRR	7.94%	29.72%	10.27%	23.36%	9.11%	26.37%

When Y and Z are both subject to federal income tax at the rates described above, and when both can use all deductions resulting from the investment against current ordinary income, Table 15 presents an accurate summary of the stakes of the three tax treatment scenarios discussed in this report.<sup>57</sup> In the real world, however, things usually are more complicated. The rest of this section flags, but does not analyze in depth, some of the complicating factors.

### B. Taxable Domestic Investors

Even when Y and Z are both domestic investors subject to federal income tax on a net basis, they might experience tax results quite different from those shown above. The ability to use deductions might be limited, such as under sections 469, 163(j), or 163(e)(5). Or Z (or Y2) might not have enough ordinary income to use the deductions. Or the parties might be subject to different effective income tax rates. It can get very complicated very quickly, but it is probably safe to say that a equity investor already subject to federal income tax on a net basis will almost always prefer equity treatment, given that it maximizes deferral and allows for a substantial

<sup>57</sup> This report does not comment on whether other possible tax treatments exist for a typical equity investment.

portion of the income to be treated as section 1231 gain eligible, in the case of a noncorporate taxpayer, for reduced rates of taxation. If the common investor can use the deductions, or, in particular, if the deal involves tax credits that the common investor values, the common investor will prefer debt treatment.<sup>58</sup>

### C. Foreign Investors

In many cases, Y is a nonresident alien or foreign corporation. When Y is foreign and its interest is treated as equity, Y's interest in XYZ causes Y to be treated as engaged in a U.S. trade or business and therefore subject to federal income tax on a net basis.<sup>59</sup>

<sup>58</sup> The tax credit point is not a small one. When a partnership generates tax credits, it must allocate them to its partners. Because most tax credits generated in the real estate context are allocated in accordance with items of income and loss, and because the equity investor typically receives allocations of some of these items if its interest is treated as equity, some of the partnership's tax credits could flow to the equity investor if its interest is treated as equity. If the equity investor's interest is treated as debt, however, all the tax credits flow to the common investor. For a detailed example illustrating the allocation of low-income housing tax credits in the partnership context, see James E. McDermott, William F. Machen, and Eric J. Lavin, "Rehabilitation Tax Credit and Low-Income Housing Tax Credit," Bloomberg Tax (Portfolio 584) at Worksheet 6.

<sup>59</sup> See section 875(1) and reg. section 1.875-1. Note that many foreign investors structure their investments in U.S. real estate through blocker corporations and thus may have different sensitivities than those discussed in this report.

If, however, Y is foreign and its interest is treated as debt, much more interesting rules apply. Though Y's interest is a "United States real property interest" under section 897, Y is not subject to taxation under section 897 unless it sells its interest.<sup>60</sup> Also, assuming (1) Y's interest is in "registered form," (2) Y is not a "10 percent shareholder" of the issuer, and (3) the issuer receives the appropriate tax forms from Y, the portion of the interest income representing Y's 10 percent IRR should be exempt from federal income tax under the portfolio interest exemption.<sup>61</sup> The portion of the interest income from the equity kicker, however, is subject to federal income tax under section 871(h)(4) and section 881(c)(4). How to separate the two different types of interest in the context of a CPDI, when interest accrues constantly based on projections that take into account both the equity kicker and the 10 percent IRR, is unclear.<sup>62</sup> Even without the portfolio interest exemption, if Y is a section 892 investor and its interest is treated as debt, its return should be entirely free from federal income tax provided it does not sell its interest.<sup>63</sup> Depending on Y's country of residence, if Y's interest is treated as debt, Y also might be able to escape federal income tax under a treaty (again, provided it does not sell its interest).<sup>64</sup>

#### D. Tax-Exempt Investors

If Y is a tax-exempt investor described in section 511(a)(2) and its interest is treated as equity, Y is subject to the unrelated business income tax on the "debt-financed" portion of its return unless Y is a "qualified organization" as

defined in section 514(c)(9)(C) and the complex requirements of section 514(c)(9)(B) are satisfied.<sup>65</sup>

If, however, Y is tax exempt and its interest is treated as debt, Y's income is interest that is not subject to UBIT, and its return should be entirely tax free.<sup>66</sup>

#### E. REIT Investors

If Y is a real estate investment trust and its interest is treated as equity, Y is treated as if it owns a proportionate share of XYZ's assets and earns a proportionate share of XYZ's income, determined based on its capital interest in XYZ.<sup>67</sup> As a result, Y will want to ensure that the property owned by XYZ is a good REIT asset producing good REIT income.<sup>68</sup>

If Y is a REIT and its interest is treated as debt, the first question to ask is whether Y's debt interest could be considered a "mortgage on real property or on interests in real property" and thus qualify as a good REIT asset.<sup>69</sup> A revenue procedure provides a safe harbor under which mezzanine loans secured by interests in partnerships or disregarded entities are treated as good REIT assets, though it is doubtful that a typical debt investment would satisfy this safe harbor.<sup>70</sup> Still, some practitioners look to a series of private letter rulings on mezzanine loans, as well as the general spirit of the REIT rules, and conclude that a typical debt investment treated as debt qualifies as a good REIT asset.<sup>71</sup>

<sup>60</sup> See reg. section 1.897-1(h), Example 2.

<sup>61</sup> See section 871(h) and section 881(c) generally and section 871(h)(4)(C)(i) in particular. See also H.R. Rep. No. 103-111, at 725 (1993). For a relevant discussion of the portfolio interest exemption and contingent interest, see Louis S. Freeman and Ryan R. Brenneman, "Contingent Interest Paid to Foreign Persons," 22 *J. Real Est. Tax'n* 81 (1994).

<sup>62</sup> For a comprehensive discussion, see Michael Yaghtmour, "OID and the Foreign Holder: Is It Really This Hard?" *Tax Notes*, June 19, 2017, p. 1707.

<sup>63</sup> See Kimberly S. Blanchard, "FIRPTA in the 21st Century, Installment Seven: Debt Issued by Partnerships," *Tax Mgmt. Int'l J.* (2012).

<sup>64</sup> See, e.g., Greece-U.S. treaty, Article VI(1), which generally exempts from federal income tax U.S.-source interest, including contingent interest, paid to Greek residents or corporations.

<sup>65</sup> A discussion of these complex rules is beyond the scope of this report. For that discussion, see NYSBA Tax Section, "Report on Section 514(c)(9)(E) Concerning Investments in Leveraged Real Estate Partnerships by Pension Trusts and Other Qualified Organizations," Report No. 894 (1997); NYSBA Tax Section, "Report on Section 514: Debt-Financed Income Subject to UBIT," Report No. 1217 (2010); David O. Kahn, "Help With Fractions: A Fractions Rule Primer," *Tax Notes*, Feb. 22, 2010, p. 953; and NYSBA Tax Section, "Report on Proposed Regulations Under Section 514(c)(9)(E)," Report No. 1368 (2017).

<sup>66</sup> For an overview of the issues involving UBIT and contingent interest (as well as guidelines), see Bradley T. Borden, "Real Estate Transactions by Tax-Exempt Entities," *Bloomberg Tax (Portfolio 591)* at II.E.

<sup>67</sup> See reg. section 1.856-3(g).

<sup>68</sup> See section 856(c)(2), (3), and (4).

<sup>69</sup> See section 856(c)(4) and 856(c)(5)(B).

<sup>70</sup> See Rev. Proc. 2003-65, 2003-2 C.B. 336.

<sup>71</sup> See LTR 8708072; LTR 8708082; LTR 8827062; LTR 200225033; LTR 200226013; and LTR 200225034. See also Stephen J. Giordano, "Fifty Shades of Gray Area: REITs Investing in Hybrid Securities," *Tax Notes Federal*, Sept. 14, 2020, p. 1985.

If Y's interest is treated as debt that qualifies as a good REIT asset, the portion of the interest income representing Y's 10 percent IRR arguably should qualify as good REIT income under section 856(c)(3)(B),<sup>72</sup> and the portion of the interest income from the equity kicker arguably should be treated as income from a shared appreciation provision that is treated as gain recognized on the sale of the property and thus could also qualify as good REIT income under section 856(c)(3)(C).<sup>73</sup>

If Y's interest is treated as debt that does not qualify as a good REIT asset, it should be treated as a security subject to the restrictions in section 856(c)(4)(B)(iv) except to the extent that section is modified by section 856(m)(4).<sup>74</sup>

## VII. Conclusion

With high returns, and with interest rates discouraging some real estate sponsors from incurring more traditional debt, debt is not going away. Tax lawyers who understand the issues discussed in this report are in a good starting position to advise their clients on the stakes presented by the different tax treatments that could apply to a debt investment. As suggested, those stakes are often quite high. The height of the stakes raises questions not answered here: When the parties have opposing preferences for the tax treatment of a debt investment, which party's preference should win out? Should compensation be paid to the party whose preference loses out? If so, how should that compensation be calculated and structured? ■

<sup>72</sup>The rule in section 856(f)(1) disqualifying certain contingent interest applies only when "the determination of [the] amount" (emphasis added) of the interest depends on income or profits and thus arguably does not apply when the timing of the interest depends on net cash flow.

<sup>73</sup>See section 856(j).

<sup>74</sup>When neither equity treatment nor exemption from section 856(c)(4)(B)(iv)(III) is feasible, the debt investor might decide to invest through a taxable REIT subsidiary to preserve its REIT status (but would then bear corporate tax on its return).

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