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Tax Aspects of Innovative Real Estate Financing

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I. THE CHANGING ECONOMICS OF LENDING

"T'was a poor loan at best, but God the interest."

Paul L. Dunbar, *The Debt*

Persistent high inflation rates and general price instability have forced a rethinking in basic lending practices. Most lenders are unwilling to make the traditional long-term, fixed-rate mortgage. Instead, a new theme has come to dominate permanent lending: equity participation.

Equity participation means that in consideration of lending money the lender receives not only fixed interest but some portion of the earnings of the property. Equity participation protects the lender against the erosion of the value of a fixed interest rate position in inflationary times. Through equity participation devices the lender participates in the increased nominal dollar earnings of a property as well as any increase in the nominal dollar value of the property. Use of such methods in lieu of short-term loans with exorbitant fixed rates may also be advantageous to the borrower. The borrower is protected against the inability to service debt in later years if a new interest rate establishes a level of debt service in excess of cash generated by the property. Under these new financing methods the brunt of the interest cost to the borrower is borne when the property is disposed of.

II. THE MANY FORMS OF EQUITY PARTICIPATION

In general, equity participation involves a sharing of income and refinancing proceeds by the lender and the borrower. There is an almost endless variety of forms but some examples are:

1. A pure equity position: The lender becomes a full partner with the borrower and in exchange for a capital contribution is given a right to a percentage of partnership items plus, in most cases, a fixed annual return equal to a percentage of the lender's capital contribution. What results in simple terms is a joint venture between the lender and the borrower.

2. A pure loan: The lender makes no capital contribution and, in form, is not a partner. As consideration for the use of money, the lender receives two forms of interest, (a) fixed interest and (b) contingent interest measured as a percentage of the net profit, or some form of gross revenues, from the operation and disposition of the property and from any refinancing of the loan.

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1 For an excellent discussion of the multiplicity of forms used for this type of financing, see the publication by the Section of Real Property, Probate and Trust Law, American Bar Association, *Financing Real Estate During the Inflationary 1980's* (1981); see also Freeman, *Interest, Contingent Interest and Original Issue Discount: Some Emerging Tax Strategies in Corporate and Real Estate Finance*, 59 Taxes 942, 955-962 (1981).
3. **A convertible pure loan:** This form is essentially the same as #2 except that, at some point, the lender has a right to convert all or part of its loan into a partnership interest. Prior to conversion, the lender may participate in profits or revenues. A right to convert is usually designed to assure the lender that it will participate in any appreciation in the value of the property in the event that no disposition occurs before the loan matures. If there is no right to convert, the loan usually requires an appraisal as of maturity and a final interest payment based upon a percentage of appreciation in the value of the property during the loan term.

4. **A convertible equity interest:** In this case the lender obtains a small “common” partnership interest in exchange for a nominal capital contribution. In addition, for the bulk of its contribution the lender receives a “preferred” partnership interest with priority rights on liquidation and a fixed preferred annual return. The bulk of losses, profits and credits are allocated to the “common” interests most of which are held by the borrower. The lender has a right to convert to a common partnership interest with increased participation in profits and losses.

5. **A combination equity interest and pure loan:** The lender may make a fixed rate mortgage loan and simultaneously obtain a partnership interest at the very outset.

6. **A ground lease:** The lender buys the land and leases it to the developer. The lender then makes a leasehold mortgage loan to the developer, the proceeds of which are used to construct the project. Ground rent is contingent, and is measured as a percentage of gross revenues or net profit. The leasehold mortgage loan may be in any of the forms discussed above.

As one can imagine, the federal income tax consequences vary considerably from form to form. Some of the issues are obvious and are answered by the Internal Revenue Code itself: for example, how a lender will be taxed if he is a partner. Other issues are more subtle — including characterization of the relationship of the lender and borrower for tax purposes, and the consequences of granting and exercising rights of conversion — and there is little meaningful guidance to assist in their resolution.

III. TAX ASPECTS OF THE FORMS OF EQUITY PARTICIPATION

A. **GENERAL**

The basic issue is how to classify the lender-borrower relationship for tax purposes. The tax benefits to be derived by the borrower from the transaction very much depend upon the nature of the lender’s investment for tax purposes. The primary tax benefit of owning real estate is derived from depreciation deductions, which depend upon the borrower’s basis in the property. If the lender is solely a creditor, the borrower can include the amount of the loan in basis for purposes of computing depreciation. If the lender is

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or is held to be) solely a partner in a joint venture with the borrower, the partnership will be able to take the same amount of depreciation deduction as would the borrowers if there were no partnership, but the borrower probably will not be able to utilize his share of the losses currently. This is so because a partner may not deduct his share of partnership losses that exceed his basis in his partnership interest. That basis includes the amount of cash and the adjusted basis of property contributed by the partner as well as the partner's share of partnership liabilities including mortgage liabilities. In almost every case the borrower's share of losses will far exceed his basis attributable solely to cash and property contributions. Consequently, if no mortgage loan is made, or if the loan transaction is recharacterized as a partnership, the borrower's basis in his partnership interest probably will not be enough to allow the borrower to fully utilize his share of the losses of the partnership. Transactions are almost always leveraged to some extent in order to provide the borrower with basis, even in a straightforward joint venture with a lender.

There are other significant tax reasons for attempting to classify the lender's investment as a debt. For certain investors, it may be desirable to receive interest payments rather than distributions taxable under subchapter K. Foreign investors, for example, are subject to tax on partnership net income from a U.S. trade or business and on capital gains from the sale of U.S. real estate, but may not be subject to tax, or will be subject to a reduced rate of tax, on "interest," payments, including payments of interest from sales proceeds. Tax exempt lenders seeking to avoid the tax on unrelated trade or business income often do not wish to have the relationship classified as a partnership. It is due to these benefits, that many transactions are structured as loans with contingent "interest."

Once the relationship is classified, many other issues will be resolved by resorting to traditional and fairly well-developed lines of authority. Thus, in form #1 (the pure equity position) the tax consequences will be governed by the rules of Subchapter K of the Code. The same rules will apply to any interest in the venture held by the lender as a partner, or to one deemed to be, although couched in terms of a lender's position.

If the lender is a partner, tax benefits such as depreciation and investment tax credits must be shared in accordance with the partnership agreement, subject to the usual limitation that the allocations must have substantial economic effect. Payments to the lender in its capacity as partner will not be deductible unless the payments are required irrespective of the income of the partnership. Thus, payments to a partner that are contingent upon net or gross income revenues may not be deductible and generally will be taxed as distributions from the partnership.

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* Section 704(d), I.R.C. of 1954.
* See Sections 871(b), 875, 882, 897(c) (1) (A) (ii), I.R.C. of 1954; U.S.-Netherlands Income Tax Convention, Article VIII.
* See Sections 511-514, I.R.C. of 1954.
* See Section 704.
* See the discussion in the text accompanying notes 2-4 supra.
* See Section 704.
* See Sections 707(a), (c); Pratt v. Commissioner, 550 F.2d 1023 (5th Cir. 1977).
without regard to income and in consideration of the use of capital are deductible. Thus, even if the lender is a partner, payments of an annual return on the lender's investment are deductible. Moreover, if the lender is a partner but is deemed to make a loan to the partnership other than in its capacity as a partner, payments of contingent as well as fixed interest arguably would be deductible.

If the lender is held to be solely a creditor, payments of fixed and contingent interest will be deductible subject to the usual rules governing interest payments. The borrower will retain all tax benefits associated with owning the real estate and will be entitled to include the amount of the debt in its basis for purposes of computing depreciation.

If the lender is held to be a creditor, the substantial interest payments at the end of the loan term, or upon disposition or refinancing of the property, create a significant tax benefit for the borrower if the gain from dispositions is taxable as a long term capital gain. For example, if the gain from the sale is $100x and the lender receives 50% of profits, the tax consequences are remarkable. In order to compute the tax on the capital gain the borrower deducts $60x, leaving taxable income of $40x. The borrower pays $50x to the lender and deducts it, producing an ordinary tax loss from the transaction of $10x. What occurs is an instantaneous conversion benefit by allowing an ordinary deduction that is simultaneously recaptured at the borrower's capital gains rate. The foregoing benefit is even greater if the payment occurs as a result of a refinancing, which is not a taxable event, or of a tax-free conversion.

B. Classifying the Relationship for Tax Purposes

The preceding discussion shows the important benefits to be derived from careful structuring of the transaction. Difficulties concerning the effectiveness of structuring the form of the transaction stem from the somewhat anachronistic system for taxing lending arrangements. Although contingent interest is not new to this era, the regimen for taxing lending transactions was conceived when loans bore a fixed rate of interest and contingent interest may have been a cause for suspicion. The general commercial lending setting has undergone a basic metamorphosis, and the courts may find themselves trying to fit the hexagonal peg of the new lending arrangements into a square hole provided by existing authorities.

The issue most frequently raised when there is significant equity participation by the lender is whether the lender will be treated for income tax purposes as a partner.

guaranteed payment within the meaning of Section 707(c) or as payments to a partner other than in its capacity as a partner, within the meaning of Section 707(a). The reasoning of these rulings could apply to payments to the lender.

11 See Section 707(c), I.R.C. of 1954.
12 See Section 707(a), I.R.C. of 1954.
13 See, e.g., Sections 163(a), 163(d), 189, 265, 461(g), I.R.C. of 1954.
14 See cases cited at note 2 supra.
15 See Section 1202, I.R.C. of 1954.
16 See Woodsam Associates v. Commissioner, 198 F.2d 357 (2d Cir. 1952).
17 See Section 1033, I.R.C. of 1954.
Whether the lender is a partner or a creditor is a factual issue that is simply a particular version of the ubiquitous debt vs. equity question. The issue is whether the parties intended to create a debt relationship or that special form of equity relationship that is a partnership. To determine that intent from objective criteria, courts rely upon the touchstones of equity investor status derived from cases involving investments in corporations as well as the following elements that are prerequisites unique to the partnership entity:

a. Sharing of losses and profits as proprietors
b. Contribution of capital or services by the partners
c. Written or other expressions of intention to form a partnership; and
d. Control over the business enterprise by the partners.

How will the typical lender equity participation fare under these tests? The answer is at best uncertain and will, of course, depend upon the facts of each case.

Assume for discussion purposes that the loan is nonrecourse and that the lender, who is not legally a partner of the borrower, will receive a significant (say, 50 percent) interest in net profits from operations, disposition and refinancing. The transaction in this example stands up well under the traditional indicia of a loan derived from corporate cases. There is (1) a fixed maturity date reasonably close in time; (2) a demonstrable intent that principal be repaid before any return to equity investors or before payments to other creditors; (3) significant fixed interest payable without regard to income; and (4) a loan to collateral value ratio that is well within commercially acceptable parameters. These facts distinguish the loan in our example from those cases where a nonrecourse loan to a partnership has been classified as equity because repayment of principal was conditioned upon profits or because the value of the security for the loan was speculative.

The question is simple: despite the presence of the usual prerequisites of a loan, will the fact that a taxpayer pays a percentage of net profits as compensation for a loan create a partnership with the lender? There are more cases dealing with this question than one might expect, and the general answer derived from those cases is that profit participation alone does not create a partnership between borrower and lender. There are also several

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18 See, e.g., Culbertson v. Commissioner, 337 U.S. 733 (1943); Dyer v. Commissioner, 211 F.2d 500 (2d Cir. 1954); Estate of Smith v. Commissioner, 313 F.2d 724 (8th Cir. 1963).


22 See Gibson Products Co. v. Commissioner, supra note 19; Rev. Rul. 72-350, supra note 19; Hartmann v. Commissioner, 17 T.C.M. 1020 (1954).

23 See Astoria Marine Construction Company v. Commissioner 4 T.C.M. 278 (1943) (a case involving a recourse loan); Mayer v. Commissioner, 13 T.C.M. 391 (1954); Arthur Venneri Company v. Commissioner, 340 F.2d 337 (Ct.Cl. 1965); Commissioner v. Williams, 256 F.2d 152 (5th Cir. 1958); cf. Duly v. Commissioner, 41 T.C.M. 1521 (1981) and Ewing v. Commissioner, 20 T.C. 216 (1953) (in both cases the court did not find a partnership despite a profit sharing arrangement).
cases involving employment agreements under which an employee received a percentage of profits as part of compensation. These, too, generally hold that the form of compensation does not convert the employment relationship into a partnership. Indeed, in some cases the Internal Revenue Service itself has argued that a transaction involving a net profit sharing arrangement was a loan, but the court at the behest of the taxpayer found a joint venture. There are also cases under other sections of the Code which sanction such contingent interest payments, the most notable and frequently cited of which is *Kena, Inc., v. Commissioner.* These precedents indicate a pronounced reluctance to characterize a profit sharing arrangement as a partnership in the absence of other indicia of partnership. Indeed, the authors of one leading treatise in the area of partnership taxation have concluded that paying a share of net profits as interest will not create a partnership between borrower and lender. Are such other indicia of partnership present in our example?

There is clearly a sharing of net profits. Because the loan is nonrecourse, it could be argued that there is also a limited form of loss sharing. The lender is the party bearing the risk of loss attributable to depreciation in the value of the mortgaged property below the partnership's equity. Although the lender's exposure is limited, limited sharing of loss is consistent with the existence of a limited partnership.

The lender ostensibly contributes no capital. As noted above its investment has most of the traditional hallmarks of debt, and it is clear that an advance of funds that is held to be a loan is not a contribution to capital. What if the court finds that there is a loan but that the fixed interest rate is below the market rate and that the right to equity participation serves as additional interest? Isn't the bargain element of the loan arguably "property" in exchange for which the lender receives its profit participation? An analogy can be drawn from the corporate area. First, a bargain sale to a shareholder has always been held to be a constructive distribution of property to the shareholders in an amount equal to the value of the bargain element. Second, the treatment of corporate instruments under Section 385 provides additional

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24 See *Friednash v. Commissioner*, 209 F.2d 601 (9th Cir. 1954); *Sugg v. Hopkins*, 11 F.2d 517 (5th Cir. 1926); *Estate of Smith v. Commissioner*, *supra* note 18; Rev. Rul. 75-43, 1975-1 C.B. 383.


26 *Kena, Inc. v. Commissioner*, 44 B.T.A. 217 (1941); (court holds that interest paid as a percentage of profit is interest); *See Murphy v. Commissioner*, 48 A.F.T.R. 2d, 81-5589 and Gardner v. Commissioner, 613 F.2d 160, 162 (dissenting opinion) in which the holding in *Kena* is cited with approval. See also *Dorzbach v. Collison*, 195 F.2d 69 (3d Cir. 1952) and *Erwin De Reitzes Marienwart v. Commissioner*, 21 T.C. 846 (1954) in which the courts held that interest payments which were measured as a percentage of profits were deductible either as interest or as the "lender's" share of partnership profits. The courts did not choose which characterization applied.


29 See, e.g., Treas. Reg. Section 1.301-1(j).
insight. Under certain circumstances, if a shareholder makes a loan to its corporation for a below-market interest rate, the lender is deemed to make a capital contribution of the excess of the consideration it paid over the value of the instrument. 30 The amount of the loan principal is constructively reduced under the regulations so that the fixed interest payment will generate a fair market return, and the amount of the reduction, i.e., the "bargain element" is treated as a contribution to capital. These precedents support an argument that the lender in our example has made a constructive capital contribution to the venture.

The nonrecourse nature of the loan is also relevant to whether there has been a capital contribution. A nonrecourse loan more closely resembles a contribution of capital put at the risk of the profitability of the enterprise than a recourse loan does. 31 Courts, however, generally refuse to attach much significance to the nonrecourse nature of a loan in real estate transactions, assuming that the collateral is of sufficient value. 32 Thus, the nonrecourse nature of the loan probably should not be very significant with respect to this element or the preceding element (loss sharing). Since nonrecourse loans are the normal commercial practice in the industry, it is not really indicative of an intent to share loss as proprietors.

Another element of a partnership is control over the enterprise by the partners. Even in a limited partnership the limited partners usually have some control over selection of general partners and major dispositions of partnership property. If, as in our example, the lender has a traditional note and mortgage and the unadorned right to contingent interest, the lender has no equity type controls. As a practical matter, however, such a case is unlikely. If the lender's return is dependent upon net profit, the lender may want some controls over management, major expenditures, dispositions, and the like. In order to protect the value of its interest in profits the lender will often have a right to convert to a partnership interest. If the right to convert is immediate or may be exercised before any major partnership action, the lender will, in substance, have equity like control over the property. The presence of these controls, the sharing of net profits and the arguable presence of other elements, provide a defensible basis for a decision that the lender is a partner. It is important to note that the cases repeatedly hold that no single element is indispensible to a finding that a partnership exists. 33

The Service could make several other arguments. For example, it is arguable that so substantial a participation in net profits is inconsistent with a debtor-creditor relationship as it is traditionally defined, particularly where nonrecourse debt is involved. Historically, a lender exchanged a higher economic return for the greater security of a lender's position and in so doing accepted a fixed interest rate. Today, the lender wants the equity holder's return as well as the security of a lender. Where the primary value of the

30 Prop. Treas. Reg. 1.385-6(c)(1).
31 See Rev. Rul. 72-135, 1972-1 C.B. 200; cf. Rev. Rul. 74-17, 1974-1 C.B. 438 (no ruling will be issued as to partnership status if a nonrecourse lender obtains an equity participation).
instrument is attributable to equity type returns, it is arguable that the entire nature of the investment changes from a debt to equity despite the absence of the typical risks of an equity investor. 34

An analogy might be drawn from the sale leaseback cases. In certain cases the putative owner-lessee has been held to be entitled to all of the depreciation from property despite an uncertain and severely limited return on investment and despite the fact that the lessee is in the position to exploit almost all meaningful appreciation in the value of the property. 35 Where the lender has the right to share in as much as 50% of all economic benefits to be derived from owning the property (more if the annual preferred return is counted), the Service could argue that the lender's stake in the equity of the property is far greater than that of the lessor in the sale leaseback cases.

The consequences of recharacterizing the entire lending transaction as a partnership are so severe that a court might search for a middle ground, particularly since the loan has many of the characteristics of debt. There are at least two plausible alternatives:

1. Treat only the equity participation as an interest in a partnership.

A court might treat the equity participation as an income interest in a partnership transferred to the lender as consideration for making the loan. The lender would be deemed to make a bona fide loan of the principal other than in its capacity as a partner. 36 The fixed interest would be deemed to be "interest" on the loan within the meaning of Section 163. 37 Such a decision could be based upon the presence of a capital contribution of the bargain element of the loan together with any equity type controls obtained by the lender. Although tax benefits would be shared by the lender, the borrower would be able to increase his basis in his partnership interest by his share of the liability and would be entitled to his share of the interest deductions for the fixed interest payments. 38

This approach is supported by Farley Realty Corporation v. Commissioner. 39 In that case a lender, who was not otherwise related to the borrower, made a loan to a corporation for a fixed interest rate (15%) and contingent interest equal to 50% of appreciation in the mortgaged property over the term of the loan. The corporation paid the lender an amount to satisfy its contingent interest obligation. The court held that the right to contingent

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36 See Section 707(a), I.R.C. of 1954.
37 Under Section 707(a) interest payments made to a partner, other than in its capacity as partner, are treated as if paid to an unrelated party. See Pratt v. Commissioner, 550 F.2d 1023 (5th Cir. 1977); Treas. Reg. Section 1.707-1(a).
38 See text accompanying notes 2-4 supra.
39 279 F.2d 701 (2d Cir. 1960).
interest constituted an equity interest in the corporation separable from the
debt and disallowed the interest deduction by the corporation.

2. Treat the equity participation as an assignment of income.

An alternative argument would be to treat the assignment of an equity participation as a negotiated, commercial assignment of income for arm's length consideration (the consideration being the agreement to make the loan). This argument has more appeal than the preceding alternative because a naked net profit interest is more like an assignment of income than a true partnership interest. If this theory were applied to our example, the borrower would retain the tax benefits. The annual allocation of taxable income to the lender could have the same effect as a deduction of interest (but would not be subject to limitations on interest deductions). On the other hand, the conversion benefit attributable to substantial interest payments upon disposition of the property would not be available. 40

Generally, a taxpayer may not make an effective, gratuitous assignment of future income, but such an assignment for arm's length consideration in a commercial setting apparently is allowable. 41 At least one court has allowed such an assignment of income despite retention of the income producing property (stock) by the owner, 42 and another court indicated that under the right circumstances such an assignment could be successful. 43 On the other hand, the Tax Court has opined strongly against such a position, albeit arguably under distinguishable circumstances. 44

The transfer of the equity participation is also analogous to a reserved income interest in mineral rights; a reserved income interest is a right retained by the transferor of mineral rights to an amount of income to be derived from the property by the transferee. In such cases some courts have held that the owner of the reserved interest, not the transferee of the property, is taxable on the reserved income. 45

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40 There are many difficult issues raised by such a theory. For example, when will interest income be reported by the lender and in what amount; what effect will the payments each year have on the borrower's taxable income when net income exceeds taxable income; how will the payments in the year of disposition be taxed? Presumably, the payment in the year of disposition would simply reduce the capital gain of the borrower so that there would be no contemporaneous conversion benefit. The difficulties stem from the absence of solid precedent dealing with an assignment of income without an accompanying assignment of the underlying property.

41 See Lyon and Eustice, Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case, 17 Tax L. Rev. 293, 298-300; Plumb supra note 34 at 442 n. 400; Dychala, Anticipating Sales of Future Income — When Includible in Income, 58 Taxes 608 (1978).

42 Stranahan v. Commissioner, 472 F.2d 867 (6th Cir. 1973).

43 See Mapco, Inc. v. United States, 556 F.2d 1107 (Cl. Ct. 1977).

44 See Martin v. Commissioner, 56 F.2d 1255 (1937), aff'd. per curiam 469 F.2d 1406 (5th Cir. 1972); Hydrometal, Inc. v. Commissioner, 31 T.C.M. 1260 (1972), aff'd per curiam 485 F.2d 1236 (5th Cir. 1973), cert. denied 416 U.S. 938 (1974).

These precedents indicate that the income interest in our example arguably represents a form of equity in the property so that the lender, not the borrower, would be taxable directly on the transferred income.

It is far more likely that a court would opt for a more conventional recharacterization of the transaction than adopt the assignment of income approach. In addition to problems with existing case law, such an approach has no effect on the allocation of tax benefits, which may be the major concern of the Service. Also, the Service is not likely to resort to this theory; by obtaining a favorable result using this theory, the Service would unleash the commercial assignment of income theory to creative planning by taxpayers.

C. Issues Raised by Corporate Borrowers.

The result may be different if the borrower is a corporation. Newly proposed regulations provide that if, on the date of issue, the value of the “straight debt payments” of an instrument is less than 50% of the fair market value of the instrument, the instrument will be treated as stock. The value of straight debt payments is essentially the sum of the present value of the rights to fixed payments of interest and principal and the value of the rights to contingent payments based upon the least amount that must be paid (and on the latest possible date of such payment) under the pertinent contingencies. In order to determine the value of the payments a reasonable discount rate must be applied to the future payments.

If the instrument is deemed to be stock, the consequences are very adverse. Although the borrower retains the tax benefits of ownership, payments of fixed or contingent interest would not be deductible since they would be deemed corporate distributions taxable under Section 301 et. seq. The corporate borrower would be taxed on the full amount of gains from disposition and would not be entitled to any deduction or offset for payments made to the lender from the sales proceeds. Compare those consequences with the less adverse consequences of the lender being a partner.

Can an instrument covered by the regulations nevertheless be deemed to create a joint venture? The regulations state that once an instrument is classified as either debt or stock the classification is effective for all purposes of the Code. Since the regulations specifically address this type of instrument, a strong argument can be made that neither the Service nor a taxpayer should be able to impose a different characterization on the relationship. Nevertheless where (1) there are indicia of a partnership, e.g., a right to convert to a partnership, or equity-like controls over a specific property, and (2) the use of the funds is limited to a specific venture of the corporation, one could argue that the partnership regime should be imposed upon the relationship and that Section 385 does not apply. As a technical matter, the argument would be that the note is not an “instrument” but a partnership agreement so that it would not be subject to Section 385.

50 The proposed regulations only apply to an “instrument,” which is defined as an interest in a corporation that is treated as indebtedness under state law. Thus, the
It might be possible to avoid the adverse consequences of applying Section 385 to a loan to a corporation by using a loan to a partnership composed of a shareholder and his corporation or to a partnership of a corporation and its subsidiary. If the partnership form is respected, the consequences of recharacterization would not involve loss of interest deductions and the borrower would be entitled to reduce its share of gains by the gains properly allocable to the lender-partner.

D. The Effect of Sharing Gross Income.

Many lending arrangements provide for a sharing of gross revenues by the lender. Using this type of contingent interest should preclude any argument that there is a partnership with the lender since the primary element, a sharing of net profit, is absent. If the definition of gross income is overly creative, so that gross income approximates net profit, the conclusion could be different. Notwithstanding the inapplicability of Subchapter K to such an arrangement, the assignment of income argument could still apply. In addition, interest that is contingent on gross income is not a "straight debt payment" for purposes of the Section 385 regulations. Consequently, the presence of such interest could cause an instrument issued by a corporation to be classified as stock.

IV. THE CONSEQUENCES OF GRANTING AND EXERCISING RIGHTS OF CONVERSION TO A LENDER.

As discussed above, for a variety of reasons, a lender will frequently be granted a right to convert all or a part of its interest into equity. The grant and exercise of the right to convert will have significant tax consequences to the lender, and the exercise of the right will have significant consequences for the borrower as well as the lender.

A. Consequences to the Lender: the Grant of the Right.

If a lender agrees to make a loan in exchange for fixed and contingent interest plus a right to convert to equity, it seems clear that the conversion right is "property" which is paid to the lender as additional interest (or as an additional cost of the loan) at the time that the lender receives the right. It would appear, then, that under the very broad definition of interest, the lender must include the value of such right, if any, as interest income at the time that the right is received. The value of the right at such time would answer to this question may well depend upon the way that the state law would treat the agreement between the corporation and its putative "creditor." See Prop. Treas. Reg. Section 1.385-3(b) and (c). See also S & M Plumbing v. Commissioner, 55 T.C. 702 (1971) and Maxwell v. Commissioner, 29 T.C.M. 1356 (1970) (cases involving joint ventures between corporations and shareholders).

Cf. Duncan Industries, Inc. v. Commissioner, 73 T.C. 266 (1979) (held: the value of a right to buy stock of the borrower at a discount, given to a lender, in the future is an additional cost of obtaining a loan). See Deputy v. Dupont, 308 U.S. 488 (1940).

depend upon a comparison of the rights of the lender under the note and as a partner. Thus, if either as lender or partner the lender will have a 50% profits interest, the extra value of the conversion right may not be substantial. If, however, the lender receives only fixed interest until conversion occurs, and the conversion will enable it to obtain a greater equity participation, the right to convert might have significant value.

Since the borrower is transferring property in satisfaction of a legal obligation to pay interest, the borrower will realize gain equal to the value of the property transferred — the right to convert. 52 Since the borrower has no basis in the right to convert, the gain recognized will equal the amount realized. 53 Although the right is transferred as an interest payment, no current deduction would be allowable because the interest relates to the entire loan term. Instead, the interest must be amortized over the loan term. 54

The foregoing analysis, however, is far from certain. The right to convert is comparable to an option to acquire property with an exercise price equal to the unpaid principal of the loan. In the compensation area it is not at all clear that the date that an option to acquire property is granted is the date that the employee is required to include the value of the option in income. The case law (and now, pertinent regulations derived from the case law) indicate that the appropriate time may be the date the option is exercised. 55 The rule derived from the cases is that the value of the option will be includible in income when the option is granted only if the value on that date is "readily ascertainable." Such value is deemed to be "readily ascertainable" only if the right is fully exercisable and transferable; it must not be subject to inhibiting conditions that would affect its value; and the property to be acquired must not be subject to restrictions or conditions. 56 It appears that the grant of the right to convert to the lender might not meet these conditions. If this analogous line of cases is applied to the lender's right to convert, the time for recognition of the income would be deferred until the right to convert is exercised, and the income would be measured by the spread between the exercise price and the value at that time. 57

B. The Exercise of the Right to Convert.

For purposes of discussion assume the following facts: The borrower ("B") owns a building subject to a $500 debt to L, with a basis of

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53 An unanswered question is when the borrower must report the income. The general rule is that payments for an option are not reported until the option is either exercised or expires. See, e.g., Hunter v. Commissioner, 140 F.2d 954 (1944). If the option is exercised the amount received is capital; if the option is not exercised, the amount realized is treated as ordinary income. The right to convert is analogous to an option. Accordingly, it could be argued that the gain should be deferred under the rules applicable to options. But what effect, if any, will the deferral have on any interest deduction allowed to the borrower? See the text accompanying note 54 infra. Since the interest will be paid or accrued when the right is granted, the deferral of the gain reportable by the borrower arguably should have no effect upon the deduction. See Sections 163, 461. I.R.C. of 1954.
54 See Section 461(g), I.R.C. of 1954.
56 See, e.g., McNamara v. Commissioner, 210 F.2d 505 (7th Cir. 1954); Commissioner v. Estate of Stone, 210 F.2d 33 (3d Cir. 1954); see also the cases cited in note 55 supra.
57 See the cases cited in note 55 supra.
$100, and a current value of $1,000. The building was originally acquired entirely with the proceeds of the $500 loan from L. The lender has a right to fixed interest of 12% plus contingent interest equal to 50% of net profit, including profit from dispositions. The loan documents provide that upon conversion, L will receive a capital account equal to the unpaid balance of the loan with a priority on liquidation, an annual return of 12% and a right to 50% of sales proceeds after positive capital accounts of all partners and the original capital of the partners are repaid.

If B is not a partnership, the transfer probably would be analyzed as follows. L should be treated as exercising an option to acquire an undivided interest in the property for an exercise price of $500, the unpaid balance of the loan. L and B then contribute their undivided interests to a new partnership. 58 Under the normal rules L would not realize income as a consequence of exercising the option even though the exercise price of $500 was less than the value of what it received ($750). 59

B has transferred an undivided interest in the property in exchange for $500. B should realize gain equal to the difference between the amount realized and its basis in the transferred interest. 60 The gain should be derived from the sale or exchange of the property so that the gain will be capital in nature, subject to the usual rules. 61 The basis would be determined by the percentage of undivided interest transferred by B. 62

If L realizes no income from the conversion (because L was required to include the value of the right to convert in income when the right to convert was granted), B presumably will not be required to realize any income attributable to the $250 value of the property in excess of the loan. Since the obligation to pay L contingent interest never accrued, B is not satisfying any obligation by transferring appreciated property to L. Consequently, there is no amount realized in excess of the $500 purchase price. In this sense B should not be treated differently from any person selling appreciated property pursuant to an option.

The new partnership's basis in the property will equal the sum of L's basis plus B's remaining basis in its retained undivided interest. 63

If L is required to include the $250 of unrealized appreciation in income when it exercises its right to convert (because the right had no ascertainable value in the date it was granted), L's basis would be increased

59 See Palmer v. United States, 302 U.S. 63 (1931); Cf. Rev. Rul. 72-265, 1972-1 C.B. 222 (No gain is recognized when taxpayer exercises right to convert bond into stock.)
60 Section 1022, I.R.C. of 1954.
61 Section 1201, I.R.C. of 1954.
62 See Rev. Rul. 67-309, 1967-2 C.B. 263. It is not simple, however, to determine what percentage interest has been transferred. If the $500 purchase price is utilized, then a 50% interest has been transferred, but if we use the $750 to which L would have a right if the property were sold immediately, a 75% interest has been conveyed. Obviously, it is to B's advantage to use the 75% figure since that means that the amount realized, $500, will be offset by 75% of B's basis in the property.
63 See Section 723, I.R.C. of 1954. L's basis should include the basis of L in the right to convert, which would equal the amount included in income when L received the right.
by $250, to $750. Since the tax consequences of the transaction are deferred until conversion, B presumably would be deemed to transfer a capital interest worth $750 to L, $250 of which should logically be viewed as additional compensation for the use of L’s money, i.e., interest. B would be deemed to transfer the $250 of value to satisfy an obligation to pay interest to L and, accordingly, should be deemed to realize $750 as a result of the conversion. If B is transferring $250 of value as interest, B should be entitled to a deduction under Section 163. If the entire loan is not canceled as a result of the conversion, and conversion occurs before the end of the loan term, the interest arguably relates to future as well as past periods. Interest that relates to future periods must be amortized over the loan term remaining after the conversion occurs. On the other hand, if upon conversion the loan term will expire, the entire amount should be deductible.

As a consequence of L’s increased basis, the basis of the new partnership in the property should be increased by $250.

Thus far we have assumed that B is not a partnership. How would the consequences differ if B were a partnership?

1. The Partners.

Under Sections 752 and 731 of the Internal Revenue Code, the partners (X and Y) will each be deemed to receive a distribution equal to their share of the released liability, or $250. Assuming for discussion purposes that each has a basis in his interest of $50 on the date of conversion, total gain recognized by the partners under these sections will be $400.

2. The Lender.

The consequences to L are less certain and depend upon how one rationalizes the series of events occurring upon conversion. Arguably, the transaction is a contribution of property by L in exchange for a partnership interest. Section 721 provides that no gain or loss shall be recognized to a contributing partner upon the contribution of property in exchange for a partnership interest. On the assumption that cancellation of debt is a transfer of property, it has generally been assumed that the cancellation is a contribution to the capital of the partnership in exchange for a partnership interest to which Section 721 applies. The rationale is that the intervening debt should be ignored and the transaction should be analyzed as if the partnership interest was received as consideration for a transfer of the property which originally gave rise to the debt. Thus, if the lender had contributed cash, instead of making a loan, Section 721 would have applied. Consequently, Section 721 should apply to the cancellation of the debt in exchange for the partnership interest. If Section 721 applies to the entire transaction, L would recognize no gain upon the conversion.

In this case L receives a partnership interest worth more than the $500 contribution of property. But the result arguably should be the

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64 Section 461(g), I.R.C. of 1954.
65 See Section 723, I.R.C. of 1954.
same as in the case of the exercise of an option by L to acquire the partnership interest. In substance, L acquired a basis in its right to convert when it included the value of the right in income. When L exercises the conversion right, it is simply applying that property right towards the acquisition of a partnership interest with a value in excess of L's basis in the property right. Under this theory, L should be treated no differently from anyone else who acquires a partnership interest in exchange for appreciated property.

This approach is consistent with the notion that the taxable event with respect to the right to convert is the granting of the right.

But what if the taxable event for L is the exercise of the right? In that case, does Section 721 override the general rule that a lender must include interest in income, including interest paid in kind? It would appear that L should be required to include the $250 as ordinary interest income; presumably the acquisition of a partnership interest in consideration of the use of borrowed money does not come within the ambit of Section 721.

Treasury Regulations under Section 721, however, may create confusion. Treas. Reg. Section 1.721-1(b) provides that Section 721 shall not apply to the extent that a partner gives up his right to a return of his original capital in order to satisfy an obligation. If the regulation is read literally, there should be no gain recognized in our example; neither X nor Y will suffer a reduction in its right to a return of capital based upon the values as of the conversion date. Moreover, payment of the principal of the debt was always senior to the right to a return of capital, so that the partners give up nothing as a practical matter when L gets a capital account equal to the unpaid balance of the debt.

If, as some suggest, an interest in unrealized appreciation is viewed as a capital interest for purposes of the regulations, X and Y are transferring a share of their interest in capital that could be subject to the regulation's exception to Section 721. If the conversion is the taxable event for L, exercising the conversion right could be construed as the satisfaction of the partnership's obligation to pay additional interest via a transfer of X's and Y's right in unrealized capital value. If this is so, under this interpretation of the regulations, L will recognize the $250 attributable to the value it receives on the date of conversion. Of course, if the conversion is not the taxable event for L there is no obligation satisfied by the conversion (except the debt) and this section of the regulations would not render Section 721 inapplicable to the conversion.

3. The Partnership.

As noted above, Section 721 might be deemed to apply to this transaction. If so, the partnership should recognize no gain from the transaction. The partnership's basis in the assets should remain unchanged, as if L had contributed $500 for its partnership interest which was used to repay the debt to L. This unfortunately results in subsequent recognition of the full amount of the unrealized gain ($900) when the property is later disposed of, even though X and Y have already recognized $400 of the gain as a consequence of Sections 752 and 731. Although the additional $400 of

See McKee supra, note 27 at 5-6.
gain would increase the basis of the partners to whom it is allocated and thereby produce a capital loss when the partnership is liquidated, this may create timing problems for the partners if the liquidation occurs in a different year from the disposition of the property.

If Section 721 does not apply to the extent of the $250 premium, the partnership would probably be deemed to transfer an undivided interest in its property worth $250 to L, who would be deemed to re奉献 the property to the partnership. 68 The partnership would recognize gain equal to the difference between $250 and its basis in the transferred interest, and it would have its basis in the property increased by $250 upon the re奉献 by L. 69 The partnership would also be entitled to a deduction for the interest payment of $250. 70

It could be argued that the entire conversion transaction should be viewed as if the partnership transferred an undivided interest in property with a value sufficient to pay the debt to L and L contributed the property to the partnership. This would make the tax consequences almost identical to those resulting if the borrower is not a partnership. The amount deemed transferred would of course depend upon whether the conversion is the relevant taxable event for L. If not, the amount realized would be $500; if conversion is the taxable event, the amount realized would be $750. The partnership would realize gain that would be allocated to X and Y. Gain attributable to the $250 premium could be offset by an interest deduction. The gain allocated to X and Y would increase their bases so that the deemed distribution under Section 752 should merely reduce their bases and not produce additional gain. This construction of the transaction mitigates the unfavorable timing consequences described above but may cause part of the gain to be taxed as ordinary income to the extent of recapture. 71

If the conversion is not the taxable event for L, so that only the $500 capital account attributable to loan principal is relevant for tax purposes, the transaction would appear to come within the scope of Section 721 and there would appear to be no authority for restructuring the transaction as a transfer of property for cash.

On the other hand if the conversion transaction is the taxable event for L so that Section 721 doesn’t apply, it is arguable that the transaction need not be bifurcated into a Section 721 contribution of $500 and a transfer of property for $250 of value to which Section 721 does not apply; the entire transaction would more easily fit into the mold of a transfer of property by the partnership to L.

68 See McDougal v. Commissioner, 62 T.C. 720, 725-26 (1964). The tax consequences should be similar to those that apply to a transfer of a partnership interest for services. For an illuminating discussion of this recondite area see McKee supra note 27 at 5-37. For a differing view of the same transaction, see Cowan, Substantial Economic Effect — The Outer Limits for Partnership Allocations, 39 N.Y.U. Tax Inst. 23-1 (1981).

69 Section 723, I.R.C. of 1954.

70 Section 163, I.R.C. of 1954.

71 See Sections 1245, 1250, I.R.C. of 1954.
VI. THE CONVERTIBLE PARTNERSHIP INTEREST (FORM #5)

This format is problematic on several accounts. First, the owner will probably have an insufficient basis in its partnership interests to exploit the additional losses allocable to the "common" partnership interests, unless a portion of the lender's contribution is in the form of a loan. 72

Second, it would appear that the use of a preferred partnership interest will not allow the owner of common interests to take the lion's share of the losses unless the requirements of Section 704(b) are met. If only L is contributing capital, L, and not the borrower, will be the partner that bears any loss to the extent of the capital it has contributed in order to obtain its preferred interest. Thus, the loss allocation to the borrower would be disallowed since it would not have substantial economic effect. Only if the borrower is obligated to make up any negative capital account will the borrower be the partner bearing the economic loss corresponding to the tax loss. 73 The fact that L's interest is "preferred" should have no effect on these rules. Consequently, the borrower does not appear to be better off under this method than if L had a 50% common interest to begin with. The losses could always be specially allocated to the borrower if the borrower is willing to make up negative capital accounts.

VII. THE GROUND LEASE FORMAT

The issues discussed with respect to the use of contingent interest apply to this format as well. The goal of this form is to allow the borrower to deduct the equity participation payments as rent pursuant to Section 162. The basic question, once again, is whether the ground lessor (lender) becomes a partner by virtue of sharing net profits with the lessee, and the same standards would apply.

VIII. CONCLUSION

The tax consequences of the new financing devices described in this article have yet to be addressed directly by the courts. Because the widespread use of new lending practices is so recent, decisions that might provide guidance are several years away. Until then, practitioners should be aware of the risks and plan accordingly.

72 See the discussion in the text accompanying notes 3-4 supra.
73 See McKee supra note 27 at 10-44 thru 10-46.