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CHAPTER 22

Real Estate as an Investment: Current Tax Planning Techniques to Increase Investors' and Developers' Returns

by

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Synopsis

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¶ 2200 INTRODUCTION

In the past, developers (*i.e.*, persons who turn raw land into improved real estate) could readily obtain construction loans to develop a real estate project and had to invest little or none of their own capital to do so. Thus, savings and loan associations, certain insurance companies, and other institutional lenders made long-term (*i.e.*, twenty- to thirty-year), fixed, and relatively low-interest-rate loans to such developers upon completion of construction. Under such circumstances, developers retained substantially all of the economic benefits from a real estate development, while lenders received only a modest share. At the same time, many institutions such as pension funds and insurance companies regarded investments in real estate as speculative, or if not speculative, then not as prudent as investments in stocks and bonds.

As a result of changes in the economy, however, there have been significant changes in the method of financing real estate projects. Thus, appreciation in real estate, even when adjusted for inflation, outpaced appreciation in other investments such as stocks and bonds (which in some cases declined in absolute value). Further, interest rates rose dramatically. As such interest rates were rising, savings and loan associations realized that they were borrowing "short" (at relatively high rates) and lending "long" (at relatively low rates). Further, traditional long-term lenders became aware that their return from a real estate investment, when compared to the developer's return, did not adequately reflect such lenders' contribution to such investment. In addition, without the availability of long-term financing, construction lenders would not make loans to developers.

These changes in the money market, in money managers' perceptions of real estate as an investment, and in the evaluation of the contribution that financing makes to real estate development created what some call the "institutionalization of real estate." Thus, pension funds and insurance companies, with billions of dollars of investment assets, concluded that investment in real estate, either as a lender or equity owner, was prudent. In addition, given the high cost of money, it was necessary to develop new methods to compensate lenders and equity investors.

This article focuses on the federal income tax issues associated with the institutionalization of real estate and discusses participating convertible debt instruments, ground lease or master lease arrangements, and certain partnership planning techniques. Taxation under state law is ignored. It should be noted that differences under state law, when compared with federal law, may change certain results.

¶ 2201 SYNOPSIS OF TAX PLANNING TECHNIQUES

¶ 2201.1 Participating Convertible Debt Instruments

The first tax planning technique which will be examined is the use of participating convertible debt instruments. In general, such an instrument usually includes a fixed annual interest rate that is somewhat below the current market rate for "straight" debt instruments. In addition, such an instrument also includes a contingent interest factor that is only due and payable to the lender if the real property's gross receipts, net profits, cash flow, sales proceeds, and/or other measures reach or exceed a certain level. The contingent factor consists of a portion of such measure, *e.g.*, 20%. The convertibility feature has the advantage of allowing the lender to continue its investment beyond the due date of the loan. In some cases, by exercising the convertibility feature, the lender may be able to improve its return.

Participating convertible debt instruments are advantageous to lenders for several reasons. Thus, if the lender is not subject to tax on interest income and if the instrument is properly structured, then the lender's return will be tax free. In addition, such instruments allow lenders to have an investment that is secured by real property with a return that may increase with inflation. Moreover, such instruments allow lenders to participate in an investment after the due date of the loan.

Such instruments are also advantageous to the borrower. If properly structured, payments to the lender (other than principal) are tax deductible interest expenses, subject to certain limitations, such as those contained in section 163(d), as amended,[1] dealing with investment interests.[2] In addition, such loans are frequently structured so that the fixed interest rate portion of the loan is below market rate; such a benefit may allow the project to operate without negative cash flow. Also, the principal amount of the loan may be an addition to the basis of the property and, if owned by a partnership, the partners' bases in their interests.

The principal disadvantage of such instruments to lenders is that in periods of disinflation, the lenders may not be able to participate in the economic benefits of the project pursuant to the contingent interest provision. From the borrower's perspective, if the project is successful such instruments will be disadvantageous since the fixed and contingent interest pay-

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[1] I.R.C. § 163(d) (1976). All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise stated.

[2] *See infra* ¶ 2202.10.

ments may exceed what would have been paid by a borrower under "straight" debt instruments. Moreover, if the project is successful, the lender may convert its interest to an equity position at the expense of the borrower's equity.

¶ 2201.2 Ground Lease or Master Lease Arrangements

The second tax planning technique is the use of a ground lease or master lease. In a typical ground lease arrangement, the lessor owns a parcel of unimproved real estate and leases it to a developer who builds an income-producing property on it. The lessor is payed a fixed, periodic ground rent, and, as in the case of a participating debt instrument, the lessor may have the right to participate in gross receipts, net profits, cash flow, sales proceeds or other measures if and when they reach or exceed a certain level. Further, the lease may also have a "convertibility" feature requiring the lessor and lessee, at the lessor's option, to become co-owners of the land and improvements.

In a typical master lease context, a master lessor of improved property, such as a shopping center or office building, leases such property to a master lessee. The master lessee then enters into leases of such property with space tenants. Such leases frequently contain a participation provision.

A ground lease or master lease arrangement is advantageous to a lessor since, as in the case of a participating debt instrument, if the lessor is not subject to tax on rental income and if the lease is properly structured, the lessor's return will be tax free. Also, as in the case of a participating debt instrument, this vehicle allows the lessor to make an investment that is secured by real property with a return that may increase with inflation. Unlike a loan, however, when the lease terminates, the lessor will, in all likelihood, become the owner of the improvements. The convertibility feature will only accelerate the timing of this result.

A ground lease or master lease arrangement is advantageous to the lessee, as well. Thus, if properly structured, payments to the lessor should all be tax deductible as rent. There are no limitations on the deductibility of rent such as those involving investment interest under section 163(d). To be deductible, rent need only be ordinary and necessary. In addition, if the lessee is a taxable entity, then all of its capital costs should be recoverable through depreciation, cost recovery allowances, or amortization. It will have no investment in land, which is only recoverable upon a subsequent sale.

A ground lease or master lease arrangement is disadvantageous to a lessor in times of inflation, when its return, attributable to the participation feature, may be lower than otherwise anticipated. With respect to a lessee, such an arrangement can be disadvantageous because the fixed and contingent rental payments may exceed a reasonable return to the lessor. Moreover, at the end of the lease term, the lessor frequently becomes the owner of the improvements, theretofore owned by the lessee, unless the lease is renegotiated. Further, if a lessor has and exercises the conversion option, then the lessee's ownership interest is diluted.

¶ 2201.3 Partnership Planning Techniques

Three partnership tax planning techniques are analyzed. The first is the use of guaranteed payments or priority distributions. A partnership agreement can provide for a specified return on invested capital in two ways. If the return is in the form of a guaranteed payment (*e.g.*, an amount equal to 10% of invested capital), the partnership's loss may be increased beyond the loss otherwise resulting from its operations. In such case, the partnership obtains a deduction for the amount of the guaranteed payment, if it is made without regard to the partnership's income and meets certain other requirements.[3] The partner who is owed the guaranteed payment is taxable on the entire amount, whether or not any money is received. In the case of priority distributions or allocations, on the other hand, as cash is available and as income is earned, a specified amount (*e.g.*, an amount equal to 10% of invested

[3] I.R.C. § 707(c) (1976).

capital) will be distributed to the partners according to their capital contributions and profit will be allocated in a similar manner. Such payments are not deductible by the partnership and may not be currently taxable to the recipient.

The second tax planning technique is the use of special allocations of bottom-line and above-the-line items. Thus, it is possible to allocate bottom-line gain or loss, or components thereof, to partners who can most benefit from them. Such allocations are respected for tax purposes if they have "substantial economic effect."[4]

The third tax planning technique is the use of the cash basis or accrual method of accounting. By utilizing the accrual method rather than cash basis of accounting, deductions can often be accelerated. Thus, under the accrual method of accounting, a deduction can be claimed without regard to whether payment has been made. There need only exist a definite liability to pay the amount and such amount must be definitely ascertainable.

¶ 2202 ANALYSIS OF PARTICIPATING CONVERTIBLE DEBT INSTRUMENTS

The participating convertible debt instrument can improve the return to a lender and a borrower because of the federal income tax consequences associated with interest income and interest expense. The key issue for analysis is whether the transaction constitutes a loan, payments with respect to which are treated as interest, or whether the transaction constitutes an equity investment by the purported lender (or a combination of an equity investment and a loan by such person).

¶ 2202.1 Determination of Interest Income and Interest Expense—In General

It is first necessary to analyze what constitutes interest income and interest expense. In general, the Code and Treasury

[4] *See* I.R.C. § 704(b) (1976).

regulation sections dealing with interest income do not contain a definition of that term. A variety of Code sections refer to interest income, including (1) section 61(4), dealing with the components of gross income, (2) section 512(b)(1), dealing with modifications to unrelated business income, (3) section 804(b)(1)(A), dealing with a life insurance company's gross investment income, (4) section 856(f), dealing with qualified income for a real estate investment trust, and (5) section 861(a)(1), dealing with U.S. source income. These sections do not, however, define the term. The Treasury regulations to the personal holding company rules, dealing with interest as a form of personal holding company income, and the Treasury regulations to the subchapter S corporation rules, dealing with interest as a form of tainted, passive income, each state that interest is an amount paid for the use or forbearance of money.[5]

On the other hand, section 163, and its regulations, specifically deal with the definition of interest expense. Section 163(a) provides that, "[t]here shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."[6] Such provision contains no limitation related to "ordinary and necessary" or to "reasonable" amounts, as is contained in section 162.

¶ 2202.2 Case Law Development of the Concept of Interest Income and Interest Expense

The development of the concept of interest income and interest expense is largely found in case law. Cases defining interest income borrow from cases defining interest expense and vice versa. Thus, these cases must be viewed cautiously. In addition, cases holding that a payment creates an interest expense deduction often have, as an alternative holding, the conclusion that the borrower and the lender are partners, thereby creating the same result for the "borrower" under partnership law. In addition, case law has emerged from a

[5] Treas. Reg. §§ 1.543–1(b)(2) (1960) and 1.1372–4(b)(5)(viii) (1960).

[6] I.R.C. § 163(a) (1976).

"plain meaning" definition of what constitutes interest to an "economic analysis" of what constitutes interest.

Early cases dealing with the issue of what constitutes interest relied on the so-called "plain meaning" analysis. The Supreme Court held in *Old Colony Railroad Co. v. Commissioner,*[7] that the amortized portion of a bond premium did not constitute a reduction of the taxpayer's interest expense attributable to the bonds. The Court provided:

> And as respects "interest," the usual import of the term is the amount which one has contracted to pay for the use of borrowed money. He who pays and he who receives payment of the stipulated amount conceives that the whole is interest. In the ordinary affairs of life no one stops for refined analysis of the nature of a premium, or considers that the periodic payment universally called "interest" is in part something wholly distinct—that is, a return of borrowed capital. It has remained for the theory of accounting to point out this refinement. We cannot believe that Congress used the word having in mind any concept other than the usual, ordinary and everyday meaning of the term, or that it was acquainted with the accountants' phrase "effective rate" of interest and intended that as the measure of the permitted deduction."[8]

The next significant case, *Deputy v. du Pont,*[9] concluded that the amount paid by a person who borrowed stock, to the lender of such stock, was not interest expense. In this case, the borrower had agreed to pay as "interest" an amount equal to the dividends received in connection with the stock, plus taxes due thereon. The Court concluded that interest constitutes "compensation for the use or forbearance of money."[10] The case at issue involved a loan of stock, rather than money.

More recent cases, however, have adopted an economic

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[7] 284 U.S. 552 (1932).

[8] *Id.* at 560–61.

[9] 308 U.S. 488 (1940).

[10] *Id.* at 498.

analysis of what constitutes interest. Thus, the Supreme Court held in *United States v. Midland-Ross Corp.*,[11] a case preceding the adoption of section 1232 (dealing with original issue discount),[12] that gain on the sale of a zero coupon bond was ordinary income and not long-term capital gain, notwithstanding that the taxpayer's holding period for the bond exceeded six months. The Court concluded that the earned original issue discount was the functional equivalent of interest income.[13]

It should be noted that, in reaching its conclusion, the Court in *Midland-Ross* relied on *Deputy v. du Pont*,[14] which is an interest expense case. Moreover, the Court disavowed *Old Colony Railroad's* rejection of esoteric and theoretical analyses of what constitutes interest.[15] The *Old Colony Railroad* case also involved interest expense.[16]

¶ 2202.3 Determination of What Constitutes an Indebtedness

A series of cases dealing with transactions deemed by the Service and courts as abusive developed the concept of what constitutes an indebtedness. In *Knetsch v. United States*,[17] the Court disallowed the taxpayer's deduction of interest incurred to purchase a single premium, thirty-year annuity, where money to purchase such annuity was obtained from the same insurance company and where the taxpayer had little likelihood of any gain, aside from the tax deduction for the interest expense. In such case the taxpayer had the right to borrow back most of the interest he had paid. Under such circumstances, the Court treated the transaction as a "fiction" that

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[11] 381 U.S. 54 (1965).

[12] I.R.C. § 1232 (1976). This section was enacted in 1969 as Pub. L. No. 91–172, Title IV, § 413(a), (b), 83 Stat. 609, 611.

[13] 381 U.S. at 57–58.

[14] 308 U.S. 488 (1940). *See supra* text accompanying notes 9 and 10.

[15] 381 U.S. at 66.

[16] Old Colony Railroad Co., 284 U.S. 552 (1932). *See supra* text accompanying note 7.

[17] 364 U.S. 361 (1960).

did not affect the taxpayer's beneficial interest, other than to reduce his taxes.[18]

A variety of real estate related cases have also developed the concept of what constitutes an indebtedness. The leading case is *Estate of Franklin v. Commissioner.*[19] In this case, the taxpayer was the limited partner of a partnership which purportedly had purchased a motel for $1,224,000. No down payment was made, but $75,000 of prepaid interest was payable immediately. The purchase price was payable over ten years, at 7½% interest per annum on the unpaid balance. Monthly payments of $9045.36 were required; a balloon payment of approximately $975,000 was due in ten years. The note was nonrecourse. The motel was leased back to the sellers, on a triple net lease basis, with rental payments approximately equal to the monthly payments on the note. The sellers were liable on the first and second mortgages until the purchase money note was paid. The sellers could, and did, encumber the property. In addition, the sellers could improve the property without the lessor's consent. While a deed was executed and delivered to the escrow holder, it was never recorded. The Tax Court held that the transaction was an option, disallowing all interest expense and depreciation deductions.[20]

The Ninth Circuit, however, reached the same result, but for different reasons. The Ninth Circuit first stated that the fair market value of the motel was less than the purchase price, preventing the partnership from developing an equity and denying any depreciation deduction to the partnership since it lacked any investment in the property. The court then stated that a transaction will not be considered to create an indebtedness if such purported debt only has economic significance if the property substantially appreciates in value prior to the time the principal is due.[21] In such a case, the purchaser has not secured the use or forebearance of money, nor

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[18] *Id.* at 366.

[19] 554 F.2d 1045 (9th Cir.), *aff'g* 64 T.C. 752 (1975).

[20] *Id.* at 1046.

[21] *Id.* at 1049.

has the seller advanced money or foreborne its use. Without any appreciation or personal liability there is only a mere chance that a genuine indebtedness will be created. The court stated that "[f]or a debt to exist, the purchaser, in the absence of personal liability, must confront a situation in which it is presently reasonable from an economic point of view for him to make a capital investment in the amount of the unpaid purchase price."[22]

¶ 2202.4 Development of the Concept of Contingent Interest

A substantial body of case law, and several revenue rulings, support the proposition that items constitute interest where they are wholly or partially contingent on the receipts or income of the borrower. In part for similar reasons, authority on the issue of what constitutes contingent interest must be viewed as cautiously as authority relating to the definition of interest income and interest expense. As in the case of interest income or interest expense, if the borrower and lender are, in fact, partners, then the so-called contingent interest is merely a partnership distribution to the purported lender and, hence, not includible in the borrower's income in the first place. Further, older cases appear less ambiguous on the issue of whether contingent interest, based on profits, for example, is interest for tax purposes than do the more recent cases.

One of the early cases in the area of contingent interest is *Kena, Inc. v. Commissioner*,[23] in which the court held that a transaction which it determined to be a loan, gave rise to interest income where such interest was measured solely and exclusively on the borrower's profits. In that case, the borrower had entered into an agreement with the taxpayer, pursuant to which the borrower (1) received money as a "loan," (2) agreed to pay back such money at a definite date, (3) agreed to pay, in lieu of interest, 80% of the profits from his stock trading business, and (4) assumed personal liability for

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[22] *Id.* at 1049.

[23] 44 B.T.A. 217 (1941).

repayment of principal. The lender had no liability for any losses of the borrower's business and no right to participate in the borrower's business. The parties stated that they were debtor and creditor.

In reaching its conclusion that the share of profits constituted interest, the court said that "[i]t is not essential that interest be computed at the stated rate, but only that a sum definitely ascertainable shall be paid for the use of borrowed money, pursuant to the agreement of lender and borrower."[24]

The next leading case is *Dorzback v. Collison.*[25] That case involved the issue of whether a payment based on a business' profits constituted an interest expense deduction. At issue was a taxpayer who owned a retail clothing store as a sole proprietor. In 1941 he borrowed $8500 from his wife, payable in one year with 5% annual interest. Although the interest was paid, principal was not. Accordingly, the taxpayer and his wife agreed that in lieu of receiving 5% annual interest, the wife would receive 25% of the business' profits. This arrangement resulted in payments to her of approximately $6900 in 1943, $7700 in 1944, and $10,300 in 1945.

The court, in holding that the wife was a creditor and that such amounts were deductible as interest, relied on *Kena, Inc.*[26] The court indicated that there was no requirement for interest to be deductible, that it be ordinary and necessary or that it be reasonable. How much interest was to be paid depended on the borrower's needs at the time in question. Thus, the fact that interest was calculated on the basis of a percentage of profits from the borrower did not prevent such interest from being deductible. (It should be noted that the district court, as an alternative to its holding that the payments constituted deductible interest, held that the payments were the wife's share of the profits of a joint venture and were excluded from the taxpayer's income.[27]

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[24] *Id.* at 221.

[25] 195 F.2d 69 (3d Cir. 1952), *aff'g* 93 F. Supp. 935 (D. Del. 1950).

[26] 195 F.2d at 72.

[27] 93 F. Supp. at 938.

Some of the more recent cases involving the deductibility of contingent interest held that such payments are either interest or the "lender's" share of a partnership, and are not includible in the "borrower's" income. Thus, in *Erwin De Reitzes-Marienwert v. Commissioner*,[28] the taxpayer's mother loaned him $25,000 to invest in a partnership in exchange for a 40% profits interest in his one-half interest in such partnership. The court held that the payments to the mother either constituted deductible interest or the taxpayer's mother's share of the profits from a subventure.[29] Further, in *Stephens Brothers v. Commissioner*[30] the lender received interest equal to 50% of the profits of a construction project, payable with respect to its $75,000 loan. The court concluded that the amount in question was not includible in the taxpayer's income, regardless of how such payments were classified.[31]

The Service has likewise endorsed the concept of "contingent interest." Thus, in Revenue Ruling 72–2,[32] the Service allowed the deduction of interest, payable in part on the basis of the borrower's income, in connection with a tuition postponement program. The Service cited *Kena, Inc.*[33] with approval, in reaching its conclusions. Further, in Revenue Ruling 76–413[34] the Service held that where a real estate investment trust was entitled to 11% annual interest, plus contingent interest equal to 1.75% of the gross receipts of the borrower, or $300 per acre, from the sale of land securing such loan, both the fixed and contingent payments were interest under section 856. This ruling also cited *Kena, Inc.* with approval.

The most troublesome case in this area and also one of the

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[28] 21 T.C. 846 (1954), *acq.* 1954–2 C.B. 4.

[29] *Id.*

[30] 24 T.C. 953 (1955), *acq.* 1956–2 C.B. 8.

[31] *Id.*

[32] 1972–1 C.B. 19.

[33] 44 B.T.A. 217 (1941). *See supra* text accompanying notes 23 and 24.

[34] 1976–2 C.B. 214. This was promulgated prior to the enactment of I.R.C. § 856(f) (1976). *See infra* ¶ 2202.9.

most recent is *Farley Realty Corp. v. Commissioner*.[35] In *Farley Realty* the borrower (the taxpayer), a corporation, had agreed to purchase a parcel of property for $380,000 if the seller would take back a $280,000 purchase money mortgage. The buyer only had $30,000 to apply to the purchase price and, accordingly, the lender loaned the buyer $70,000 for ten years, with annual interest payable at 15% for the first two years, and 13% for the remaining eight years. Further, the lender was to receive 50% of any appreciation in the value of the property.

At issue was whether a $50,000 contingent payment made by the buyer to the lender was deductible. The court held that the lender's right to receive repayment of the $70,000 loan with fixed interest was separate from his right to a 50% participation in appreciation, which was an equity interest. The court held that interest must be a fixed percentage of a loan.[36] Thus, even if the only interest under the loan was contingent interest, this would not constitute interest. Moreover the "loan" lacked a fixed maturity date.

The most disturbing point contained in the case is that the court in *Farley Realty* distinguished the *Dorzback* case. The court provided that in *Dorzback*, the borrower was not a corporation and that the result would have been the same whether the wife-lender was a joint venturer or creditor. The court stated that if *Dorzback* recognized contingent interest as interest, then such court was incorrect.[37]

¶ 2202.5 Distinguishing Loans From Equity Investments: Loan vs. Partnership Arrangement

In addition to determining whether an amount constitutes interest and whether an arrangement constitutes indebtedness, it is also necessary to distinguish a loan from an equity investment. This issue arises both in the partnership and cor-

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[35] 279 F.2d 701 (2d Cir. 1960), *aff'g* 18 T.C.M. (CCH) ¶ 23,589(M), at 422, 28 T.C.M. (P-H) ¶ 59,093, at 59–367 (1959).

[36] 279 F.2d at 704.

[37] *Id.* at 705.

porate context. In the partnership context, the leading case in the area of whether a person is a partner or a lender is *Commissioner v. Culbertson.*[38] The court held:

> The question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the *Tower* case, but whether, considering all of the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.[39]

An analysis of other cases in the partnership area indicates that whether a person is a partner or a lender depends upon the relevant facts and circumstances. Thus, in *Hartman v. Commissioner,*[40] the taxpayer purportedly loaned $5000 to be repaid out of the first profits of the borrower's business, together with 6% annual interest until paid. When repaid, the lender would receive half of the borrower's profits. The court held that the $5000 investment was a capital contribution by a partner.

In reaching its conclusion, the court stated that the existence of a partnership depends on whether the parties intended to carry on a business and share in its profits and losses. Conversely, the court stated that "[f]or a true loan it is essential to provide for repayment absolutely and in all events, or that the principal be secured in some way as distinguished from being put in hazard."[41] The court considered important the fact that the money at issue was only payable out

[38] 337 U.S. 733 (1949).

[39] *Id.* at 742. *See* Commissioner v. Tower, 327 U.S. 280 (1946).

[40] 17 T.C.M. (CCH) ¶ 23,271(M), at 1020, 27 T.C.M. (P-H) ¶ 58,206 at 58–881 (1958).

[41] *Id.* at 1023, 27 T.C.M. (P-H) at 50–883.

of profits, that no note was given, and that there was a proprietary interest in the profits.

In *Luna v. Commissioner,*[42] the court listed a variety of factors to determine whether a person is a partner or lender including (1) the agreement of the parties and their conduct in executing its terms, (2) the contributions which each party has made to the venture, (3) the parties' control over income and capital and their rights of withdrawal, (4) whether each party is a principal or one is the agent of the other, (5) how losses are shared, (6) the form in which business is conducted, (7) agreements, books and records, and tax returns of the parties, and (8) whether the parties exercised mutual control over the enterprise.

In *Hambuechen v. Commissioner,*[43] the court's analysis of whether a person was a partner or lender was borrowed from cases dealing with whether a person is a shareholder or a creditor of a corporation. Thus, the court looked to (1) the adequacy of the purported debtor's capitalization, (2) the existence of a note, provision for and payment of interest, and presence or absence of a maturity date, (3) the intention to repay and the reasonableness of the expectation of repayment, (4) whether the purported debtor subordinated its rights to other claims of creditors, (5) whether outside creditors have made similar advances, (6) the presence or absence of security, and (7) the use to which funds are put.

As might be anticipated, the Service has taken a conservative approach to the issue of whether an advance is a loan or a contribution to the capital of a partnership. Thus, in Revenue Ruling 72-135,[44] the Service determined that a purportedly non-recourse loan from the general partner of a limited partnership, engaged in oil and gas exploration, to such limited partnership, constituted a capital contribution by the general partner. Further, in Revenue Ruling 72-350,[45] the Service de-

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[42] 42 T.C. 1067 (1964).

[43] 43 T.C. 90 (1964).

[44] 1977-1 C.B. 200.

[45] 1972 -2 C.B. 394.

termined that a purportedly non-recourse loan, secured by unproven oil and gas leases and some unsalvagable oil and gas installations, where the purported lender could convert to a 25% partnership interest, was, in fact, a capital contribution to the venture. In any event, what makes the Service's analysis difficult for the tax planner is trying to respond to the issue of distinguishing between a non-recourse loan to a partnership and a capital contribution by a partner. This analysis is made more complicated if the loan contains a contingent interest provision.

A variety of consequences follow if a purported lender to a partnership is, in fact, reclassified as a partner. First, payments of fixed or contingent interest may still be classified as interest expense if and to the extent section 707(c) applies.[46] Second, payments of principal will be treated as distributions to partners. Pursuant to section 731, such distributions are only taxable to the extent they exceed a partner's adjusted basis in its partnership interest. Where such basis is exceeded, gain will be taxable as capital gain or ordinary income, pursuant to sections 731 and 751, depending upon a variety of factors. Third, the lender will have a basis in its partnership interest equal to its advance to the partnership plus its share of partnership loans. The other partners bases in their partnership interests will not include the amount of the "lender's" advance. Finally, the other partners' share, if any, of the partnership's loans included in the bases of their partnership interests will be reduced by the "lender's" interest in the partnership. (The partnership's basis in its assets, however, will not be changed.)

¶ 2202.6 Distinguishing Loans From Equity Investments: Loan vs. Shareholder Arrangement

In determining whether a person is a shareholder or a lender, section 385 and the regulations thereunder, if and when made effective, will govern the issue. Pursuant to section 385, such regulations may consider factors including (1) whether

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[46] *See infra* ¶ 2204.1.

there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate monetary consideration, and to pay a fixed rate of interest, (2) whether there is subordination or preference with respect to other debt, (3) the corporation's debt equity ratio, (4) whether the debt is convertible into stock, and (5) the relationship between the holdings of the debt and the stock interest.

Treasury Regulation section 1.385–2(a)(2) and (b)(2) provides that in the case of "hybrid" instruments issued proportionally to stock ownership, such instruments are treated as stock; hybrid instruments not issued proportionally are treated as stock only if their equity features are "predominant." A hybrid instrument is one that is convertible into stock or one that provides for any contingent payment (other than a call premium), such as an income or participating bond.

In the case of a hybrid instrument issued non-proportionally, it is treated as preferred stock if, on the date of issue, the fair market value of the instrument without the equity feature is less than 50% of its value with the equity feature.[47] An equity feature is the right to convert to stock or to receive contingent payments.[48] Treasury Regulation section 1.385–5(e), Example (6), contains an example of a contingent payment. Thus, a lender loaned $300,000 and the borrower agreed to pay $175,000 "in lieu of interest," as the borrower sold each of the 350 houses it planned to build. The principal was payable on demand after December 31, 1990. The $175,000 was treated as a contingent payment pursuant to these regulations.

Unlike the partnership area, where a variety of factors are considered to determine whether a person is a lender or partner, the only relevant factors in the corporate area, pursuant to the regulations under section 385 are whether the hybrid

[47] Treas. Reg. § 1.385–5(a) (1980).

[48] Treas. Reg. § 1.385–5(b) (1980).

instrument is held proportionally to stock holdings and what its fair market value is without the equity feature.

If a hybrid instrument is classified as stock, then it is classified as preferred stock.[49] In such a case, payments of "interest" are treated as distributions to which section 301 applies and payments of principal are treated as distributions and redemptions of stock under section 302. Such distributions, if taxable under section 301, will be treated as dividends to the extent of current or accumulated earnings and profits.

¶ 2202.7 Tax Aspects of the Convertibility Feature

In the partnership area, there are a number of unanswered questions with respect to convertible loans made by persons who exercise the convertibility feature and become partners. Thus, if any value is attributable to the convertibility feature, then, will the partnership recognize any gain when it is granted, when it lapses, or when it is exercised? These issues await answering by Congress, the courts, and the Service.

Upon exercising the convertibility feature, a number of events will occur in the partnership context. Thus, in the case of the lender, the lender will become a partner and will have a basis in its partnership interest equal to the unpaid principal of its loan at the time of conversion, plus its share of the partnership's recourse loans (if it is a general partner) and non-recourse loans. The lender's share of the adjusted basis in the partnership property will probably be less than its basis in its partnership interest. (In all probability, sections 754 and 743 do not apply to this conversion.) Moreover, pursuant to section 721, the conversion of the loan should be treated as a tax-free capital contribution.

This analysis assumes that the lender's share of the equity is based on the relative value of the partnerships' assets at the time the loan is made, compared to the amount of the loan itself. Thus, there is a further question as to whether the same results follow if the lender's share of the equity is

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[49] Treas. Reg. § 1.385–4(c)(1)(i) (1980).

greater or lesser than its proportional share of its loan when compared to the value of the property at the time the loan is made.

In the case of the other partners, they will no longer be allowed to include in their bases in their partnership interests, the amount of the converted loan. Moreover, their share of profits and losses will be reduced. Thus, under section 752, the loss of basis attributable to the elimination of the loan and the reduction of interest in the partnership could generate gain to such other partners. Given this consequence, it is necessary to stage the conversion so that the original partners do not recognize any gain.

As discussed above, in the corporate context, the presence of a convertibility feature will cause a note to be treated as a hybrid instrument. Further, options to convert a note must be taken into account in calculating original issue discount.[50] Assuming, however, that the transaction constitutes a loan, at the outset, the conversion of the loan should be treated as a tax-free recapitalization under section 368(a)(1)(E). If the convertibility feature lapses, the issue that arises is whether the maker of the note realizes any gain.[51]

¶ 2202.8 Special Considerations Applicable to Qualified Pension Trusts

Many of the lenders making participating convertible loans are qualified pension trusts and real estate investments trusts. These entities have unique problems related to these types of instruments. Thus, in the case of a pension trust, if the compensation in question is treated as interest, then such amount is not taxable to it. This result follows because under section 501(a) and (b), a qualified pension trust (and other entities not here relevant) is exempt from federal income tax except to the extent of its unrelated business income. Under section 512(a)(1), the term "unrelated business taxable income" is defined to mean gross income derived from an unrelated

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[50] I.R.C. § 1232(b)(2) (1976); Treas. Reg. § 1.1232–3(b)(2)(ii) (1971).

[51] *Cf.* Rev. Rul. 72–198, 1972–1 C.B. 223; it provides for gain to an issuer of corporate warrants on their lapse.

trade or business regularly carried on, less associated deductions and modifications. Section 513 states that an unrelated trade or business is a trade or business whose conduct is not substantially related (other than by the need of an organization for income) to its exempt purpose. Section 512(b) indicates that interest is one such modification; that is, interest is excluded from the calculation of unrelated business taxable income.

The important issue in the context of interest income earned by a qualified pension trust is whether "active" (as opposed to "passive") interest is a modification for purposes of section 512(b). In general, the term "passive" interest refers to interest based on a stated percentage of the principal of the loan or a percentage of the gross receipts or sales of the borrower. "Active" interest is a percentage of the borrower's profits from operations or from a dealer-type activity, such as the sale of condominiums.

Analysis of the unrelated business income statute suggests that any item, so long as it is interest, is non-taxable, even if derived from the business of the borrower. The legislative history of the unrelated business income provisions confirms such analysis. Both the House and Senate reports to such provision indicate that the exception for interest is not only intended to apply to "investment" income but also to business interest on overdue accounts receivable.[52] Further, the legislative history of section 856(f) limiting allowable interest for real estate investment trusts to "passive" interest indicates that such provision is to have no effect whatsoever on the definition of the term interest for any other purpose.[53] Moreover, in Revenue Ruling 79-349[54] involving a qualified pension trust that continually owned a substantial number of mortgage loans which it originated and which formed a significant

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[52] *See* H.R. REP. No. 2319, 81st Cong., 2d Sess. (1950), 1950-2 C.B. 380, 459; S. REP. No. 2375, 81st Cong., 2d Sess. (1950), 1950-2 C.B. 483, 560.

[53] *See* H.R. REP. No. 658, 94th Cong., 1st Sess. (1975), 1976-3 C.B. (Vol. 2) 695, 1059; S. REP. No. 938, 94th Cong., 2d Sess. (1976), 1976-3 C.B. (Vol. 3) 49, 514. *See also infra* ¶ 2202.9.

[54] 1979-2 C.B. 233.

part of its assets, the Service held that the trust was engaged in the business of making mortgage loans. The Service provided that the interest income was not taxable (although the loan fees were). In any event, while the Service has not finally expressed a view on the issue, it can be assumed that so long as a qualified pension trust's interest income is no more active than that allowed a real estate investment trust under section 856(f) then such amounts will be treated as interest.

If a qualified pension trust's loan is treated as equity, a number of consequences follow. If the borrower is a corporation and if the regulations under section 385 are finally adopted, then distributions by the borrower to a qualified pension trust should not be taxable to it either because they are dividends, return of capital, or gain on redemption of the stock interest.[55]

If, on the other hand, the borrower is a partnership (whether or not a limited partnership), the qualified pension trust most likely will be deemed a partner and will be deemed to be engaged in whatever business the partnership is engaged in.[56] If the partnership is engaged in a business generating dealer-type income, such as from the sale of inventory or property held primarily for sale to its customers, then the pension trust will owe tax on its distributive share of its partnership's income. On the other hand, if the partnership's income constitutes rent from real property for purposes of section 512(b)(3),[57] then the pension trust will not be taxable on its distributive share of such partnership's income. The only exception applies if the partnership owns debt financed property, in which case the pension trust will be subject to tax on all or a portion of its income from such partnership. However, there is an exception to the debt financed property rules which is found in recently enacted section 514(c)(9).[58] It should be noted that the legislative history to section

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[55] *See* I.R.C. § 301 (1976); I.R.C. § 302 (1976); I.R.C. § 512(b)(1), (b)(5) (1976).

[56] I.R.C. § 512(c) (1976); Rev. Rul. 79–222, 1979–2 C.B. 236.

[57] *See infra* ¶ 2203.3.

[58] I.R.C. § 514(c)(9) (Supp. V 1981).

514(c)(9) indicates that a pension trust's share of a partnership's debt in which such pension trust is a partner will be tested by the standards of such new provisions.

¶ 2202.9 Special Considerations Applicable to Real Estate Investment Trusts

Special considerations also apply in the case of a real estate investment trust (REIT). In order to qualify as a real estate investment trust, certain portions of the trust's income must be derived from specified sources, including "interest" and "interest on obligations secured by mortgages on or interests in real property."[59] Section 856(f) provides that for purposes of sections 856(c)(2)(B) and 856(c)(3)(B), the term "interest" excludes any amount that depends in whole or in part on the income or profits of another person. There are two exceptions to this latter rule. The first applies to amounts based on a fixed percentage or percentages of receipts or sales of the borrower. The second applies where a REIT receives or accrues an amount based on the receipts or sales of the debtor and the debtor receives or accrues an amount based on the income or profits of another person; only the latter portion is excluded from the definition of interest.

In any event, section 856(f) does not define interest; rather, it merely indicates what items are excluded from the definition of interest under the REIT rules. However, Treasury Regulation section 1.856–5(a) states, as a general rule, that the term "interest" only includes an amount which constitutes compensation for the use or forbearance of money. If a loan provides for both a fixed amount of interest and a percentage of the borrower's income or profits, neither type of interest will qualify.[60] Whether an amount is received or accrued with respect to another person's income or profits is determined pursuant to the rules governing rental income of REITs (discussed below).[61] As discussed above,[62] Revenue

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59 I.R.C. § 856(c)(2)(B), (c)(3)(B) (1976 & Supp. V 1981).

60 Treas. Reg. § 1.856–5(b) (1981).

61 *Id. See infra* ¶ 2203.3.

62 *See supra* note 34.

Ruling 76–413 provides that when a REIT makes a loan with a fixed interest rate and with a rate based on a fixed percentage of the debtor's gross sales, or an absolute fixed amount per acre, if greater, both features constitute interest for purposes of the REIT rules.

Several consequences follow if a loan from a REIT is deemed equity. If the "borrower" is a corporation, then any dividends or payments in redemption of its stock should still be treated as qualified income to the REIT. However, there are limits to the amount of dividend and other income a REIT can receive.[63] On the other hand, if the "borrower" is a partnership, and such partnership is generating rental income, such income should also be treated as qualified income to the REIT.[64] If such partnership's income is from a "dealer-type" activity, then such income will probably be tainted under section 856(c).

¶ 2202.10 Other Tax Planning Considerations

A number of other factors should be considered by tax planners utilizing participating convertible debt instruments. If an instrument provides that "interest" is accrued subsequent to the time the loan is repaid, such amount will probably not be treated as interest. Thus, such "interest" is not paid with respect to an indebtedness. This consideration highlights an important limitation of a participating loan: the participation feature stops when a loan is repaid. Only by converting such loan to an equity position is it possible for the lender to continue the participation.

Some commentators believe that if the participation percentage is too high, *e.g.*, 50% or more, then the Service will disallow the item as interest expense and treat the parties as co-owners, partner/partnership, or shareholder/corporation. This perception may be more accurate in the corporate than in the partnership context. Thus, pursuant to Treasury Regu-

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[63] I.R.C. § 856(c) (1976 & Supp. V 1981).

[64] *Id.*

lation section 1.385–5(a), such a percentage factor affects the fair market value of the instrument for purposes of determining if such instrument, if held non-proportionally to stock, constitutes debt or equity. The fair market value of an instrument without such a participation feature would depend, at least in part, upon the fixed rate interest portion of such note, if any, relative to the market, and the current and future anticipated levels of inflation. In a creditor-versus-partner context, cases like *Luna*,[65] and *Hambeuchen*,[66] indicate that, at best, the rate of the participation is only one factor to consider in determining whether the purported loan constitutes an equity investment.

Borrower's tax advisors should also consider the impact of the alternative minimum tax and alternative tax when their client enters into a participating loan. To illustrate the impact of these taxes, assume that on a sale of property, a borrower generates a $5 million long-term capital gain and owes the lender $2.5 million in additional interest as the lender's share of the sales proceeds. If the borrower is an individual (or a partnership composed of individuals), 40% of the $5 million long-term capital gain, or $2 million, is taxable. Assume that the $2.5 million payment constitutes interest that is not investment interest. Then, as a result of this transaction, the seller/borrower has $(500,000) of taxable income and will not owe any federal income tax. From an alternative minimum tax perspective, however, the transaction generates alternative minimum taxable income of $2.5 million (*i.e.*, taxable income of $(500,000) plus the untaxed portion of the long-term capital gain of $3 million). The alternative minimum tax is approximately $492,000.

If the borrower is a corporation, then it will have $2.5 million of taxable income and owe approximately $1,130,000 in income taxes. Pursuant to the alternative tax, which is paid if lower than the regular tax, the corporation will owe 28% of the entire $5 million long-term capital gain, generating $1.4

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[65] 42 T.C. 1067 (1964). *See supra* note 42.

[66] 43 T.C. 90 (1964). *See supra* note 43.

million of alternative tax. In this case the regular tax is lower.[67]

In the case of non-corporate taxpayers, including such persons who are partners in partnerships, section 163(d) limits the ability to deduct so called "investment interest." The term "investment interest" means interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment.[68]

As a general matter, property subject to a lease is not treated as investment property. Thus, interest paid in connection with the purchase of such property is not investment interest. Two exceptions to this rule apply. First, interest will be considered as investment interest if the sum of the deductions of the lessor with respect to such property allowable under section 162, other than rents and reimbursed amounts, are less than 15% of the rental income produced by such property, *i.e.* , the lease is a "net lease." Second, interest will be considered as investment interest if the lessor is guaranteed a specified return or is guaranteed, in whole or in part, against loss.[69]

Any borrower potentially subject to the investment interest limitation rules should plan carefully to avoid the disallowance of the deduction for interest. In general, interest paid in connection with an apartment project should not constitute investment interest because of the owner's payment of substantial expenses. However, in the case of a triple net lease property, a net lease for purposes of section 163(d) will probably exist.

It is possible for pension trusts to pool their investments and make loans in the context of a so-called "group trust." If a group trust meets the requirements set forth in Revenue Ruling 81–100,[70] it will be exempt from federal income tax under section 501(a).

[67] I.R.C. § 1201(a) (1976 & Supp. V 1981).

[68] I.R.C. § 163(d)(3)(D) (1976).

[69] I.R.C. § 163(d)(4)(A).

[70] 1981–2 C.B. 326 (1976).

Prior to the 1980 enactment of the Foreign Investment in Real Property Tax Act (FIRPTA),[71] it was relatively easy for a non-resident alien or foreign corporation to structure an investment in U.S. real estate to avoid any capital gains tax on the sale. As a result of FIRPTA, such sales of U.S. real estate generally will be taxed in the same manner as such sales made by citizens of the United States.

To the extent that interest income is paid by an entity owning U.S. real estate to the non-resident alien or foreign corporation owning such an entity, such interest is deductible by such entity, to the extent of and subject to the caveats discussed above. Further, pursuant to sections 871(a) and 881(a) the U.S. tax rate on such interest cannot exceed 30%, provided such income is not effectively connected with the conduct of a U.S. trade or business. Pursuant to various income tax treaties to which the United States is a party, such 30% rate has been lowered. Accordingly, it may be advantageous for an investor to structure part of its investment in U.S. real estate as a loan whose interest payments are subject to withholding at a rate lower than the capital gain rate. However, a lender will want to restructure the transaction to avoid being treated as a shareholder or partner with respect to such loan.

¶ 2202.11 Guidelines in Structuring a Participating Convertible Debt Instrument

In structuring a participating convertible debt instrument, several guidelines should be followed. First, the note should provide for a fixed maturity date and for payment of principal and interest at that time without regard to the borrower's ability to pay. Second, the lender should have minimal approval and management rights over the borrower's activities; the lender should provide no services to the borrower. Third, to be conservative, the participation feature should be based on the borrower's gross receipts or sales rather than on its net income or profits. (This is mandatory in the case of real estate

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[71] Foreign Investment in Real Property Tax Act of 1980, Pub. L. No. 96–499, 94 Stat. 2599 (codified at I.R.C. §§ 861, 871, 897, 6039(c)).

investment trusts as lenders). Fourth, the borrower should have an equity in the development. If possible, the loan should be adequately secured. The lender should not be liable for any of the borrower's losses. Fifth, the intention of the parties should be clearly documented. A "note" or "loan agreement" should be used; the participation should be described as "interest" or "additional interest." Sixth, the loan should not be subordinated to any other creditors' advances.

¶ 2203 GROUND LEASE OR MASTER LEASE ARRANGEMENTS

As in the case of a participating convertible debt instrument, the ground lease and master lease arrangements are advantageous to both lessors and lessees because of the federal income tax consequences associated with rental income and rental expense. In this context, the key issue is whether the transaction constitutes a lease, payments with respect to which are rent, or whether the transaction is a financing transaction.

¶ 2203.1 Determination of Rental Income and Rental Expense — In General

As in the case of interest income, neither the Code nor Treasury regulations explicitly defines rental income. A variety of Code sections refer to rental income, including (1) section 61(5), dealing with the components of gross income, (2) section 512(b), dealing with modifications to unrelated business income, (3) section 804(b)(1)(A), dealing with a life insurance company's gross investment income, (4) section 856(d), dealing with qualified income for a real estate investment trust, and (5) section 861(a)(4), dealing with U.S. source income. The Treasury regulations relating to the definition of gross income, the personal holding company rules (dealing with what types of rental income constitute personal holding company income), and the subchapter S corporation rules (dealing with what constitutes tainted, passive income) all state that rental income is compensation for the use, or the right to use property.[72] Conversely, section 162(a)(3) provides for a deduction for rental expense if such payment is ordinary and necessary to carry on a trade or business, if it is required to be made for the use or possession of property, and if the taxpayer is not taking title to the property and has no equity in the property.

¶ 2203.2 Case Law Development of Rental Income and Rental Expense

Unlike the interest area, there is not an extensive body of case law regarding whether an amount, be it fixed or contingent, constitutes rent. There is, however, extensive authority on the issue of who owns a parcel of property. In Revenue Ruling 69–93,[73] the Service held that where *A* and *B*, in October 1967, entered into a contract to purchase and sell real estate, the conveyance to take place on March 1, 1968, and where the seller received a nominal earnest money payment, the seller was not taxable on the sale until March 1, 1968. In the interim, the seller retained legal title and the right to possession, rents and profits. The Service held that the sale occurred when the deed passed or when possession and the burdens and benefits of ownership passed. Moreover, even where an optionee has possession of property, the optionor can still be considered to be the property owner.[74]

There is also extensive authority on the issue of whether a transaction is a lease or other arrangement. The leading case in this area is *Frank Lyon Co. v. United States.*[75] However, in order to understand the significance of the *Frank Lyon Co.* case, it is necessary to analyze the cases preceding it.

The leading pre-*Frank Lyon Co.* case is *Helvering v. F. &*

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[72] Treas. Reg. § 1.61–8(a) (1960); Treas. Reg. § 1.543–1(b)(10) (1960); Treas. Reg. § 1.1372–4(b)(5)(vi) (1960).

[73] 1969–1 C.B. 139.

[74] *See* Rev. Rul. 54–607, 1954–2 C.B. 177. *See also* Helvering v. San Joaquin Fruit and Investment Co., 297 U.S. 496 (1936).

[75] 435 U.S. 561 (1978). *See infra* text accompanying notes 82–85.

R. Lazarus & Co.[76] In that case, the taxpayer transferred legal title to two buildings and a ninety-nine-year leasehold estate in a third building to a bank as trustee on behalf of certain land trust certificate holders. The three properties were then leased back to the taxpayer for ninety-nine years with options to extend the lease terms and to repurchase the properties. The Service took the position that the income tax incidents followed legal title and attempted to deny the taxpayer's depreciation deductions. The taxpayer argued that it retained the burdens and benefits of ownership and that the purported sale and leaseback was merely a financing transaction.

The Supreme Court sided with the taxpayer, pointing out that although the burden of wear and tear and exhaustion of business property normally falls on the party that holds legal title, such is not always the case.[77] Lessees who bear such burden may be found to be the equitable owner of the property for tax purposes.

Then, in *Oesterreich v. Commissioner*,[78] the court held that when a purported sixty-eight-year ground lease provided for larger rental payments in the earlier years and smaller payments in the later years, with an option to purchase for $10, the lease was, in fact, a contract for sale. Later, in *Frito-Lay Co., Inc. v. United States*,[79] the court held that the taxpayer's payments were not rent where the taxpayer conveyed land to a subsidiary and the subsidiary conveyed it to a contractor who leased it back to the taxpayer and constructed a building on it. The rent was 7½% of the building's cost. The taxpayer's subsidiary had been granted a twenty-year option to buy the land for its then fair market value.

Two other cases developed this concept further. In *American Realty Trust v. United States*,[80] the court upheld a sale

[76] 308 U.S. 252 (1939).

[77] 308 U.S. at 254.

[78] 226 F.2d 798 (9th Cir. 1955), *rev'g* 12 T.C.M. (CCH) ¶ 19,522(M), at 277, 22 T.C.M. (P-H) ¶ 53,085, at 53–273 (1953).

[79] 209 F. Supp. 886 (N.D. Ga. 1962).

[80] 498 F.2d 1194 (4th Cir. 1974), *aff'g* 1973–2 U.S. Tax Cas. ¶ 9796 (D. Va. 1973).

and leaseback transaction where the lease provided, *inter alia*, triple net terms, a reduction in rent equal to 50% of any reduction in the underlying mortgage and the right for the lessee to share in the proceeds of any refinancing or condemnation. Finally, in *Sun Oil Co. v. Commissioner*,[81] the court determined that a lease executed in connection with the lessee's sale of 320 service stations to the lessor was a financing transaction where such lease provided, *inter alia*, (1) an option to purchase at fair market value, (2) that the lessee could terminate any lease when the operation of the business became uneconomical, (3) that payments to the lessor provided a repayment of investment plus a fixed return, (4) that all the costs of the property were borne by the lessee, and (5) that the lessee could make a rejectable offer to purchase which, if rejected, would allow the lessee to substitute property.

The *Frank Lyon Co.*[82] case represents the Supreme Court's latest holding on the issue of whether a sale and leaseback transaction will be respected as such. At issue was Worthen Bank and Trust Company ("Worthen") which, for valid business reasons, needed to, but was unable to construct a building for its use. Alternatively, Worthen proposed a sale and leaseback transaction with Frank Lyon Company. (Although the principal shareholder of Frank Lyon Company sat on the Worthen board of directors, the Court found that all dealings were at arm's length.)

Worthen retained ownership of the land which it leased to Frank Lyon Company for seventy-six years and seven months (the construction period was estimated at one year and seven months). The rental was $50 per year for the first twenty-six years and seven months; thereafter rentals increased from $100,000 per year to $200,000 per year for the next forty years and finally decreased to $10,000 per year for the final ten years. Worthen constructed the building and sold it piece-

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[81] 562 F.2d 258 (3d Cir. 1977), *rev'g* and *rem'g* 35 T.C.M. (CCH) ¶ 33,664 (M), at 173, 45 T.C.M. (P-H) ¶ 76,640, at 76–170 (1976).

[82] 435 U.S. 561 (1978).

by-piece to Frank Lyon Company for $7,640,000. Frank Lyon Company secured a first mortgage from New York Life Insurance Company for $7,140,000 of the total cost, investing $500,000 of its own funds.

The building was leased back to Worthen for an initial twenty-five-year term for a rental which would completely amortize the New York Life loan, which also ran for twenty-five years. If Worthen elected to extend the lease, the rental was reduced to $300,000 per year (offset, in part, by increased rentals paid to Worthen by *Frank Lyon Co.* under the ground lease). If all renewal options were exercised, the net return to Frank Lyon Company would equal a return of its $500,000 investment plus annual interest at 6%.

Worthen was given an option to repurchase the building for amounts which would decrease over the term of the lease and which, if exercised, would be sufficient to repay the New York Life loan and Frank Lyon Company's $500,000 investment together with 6% annual interest.

The Court decided that the arrangement constituted a valid sale and leaseback transaction. The Court reasoned that had Worthen made a sale and leaseback arrangement with New York Life directly, then *Lazarus*[83] would have applied. Under these facts, however, it was the taxpayer who was solely liable on the loan from New York Life (*i.e.*, there was "a distinct element of economic reality in Lyon's assumption of liability.").[84]

The Court rejected the Service's theory that Frank Lyon Company's $500,000 equity investment represented a loan to Worthen. Thus, there was no note evidencing a debt and the only way in which Frank Lyon Company could realize the assumed 6% return would be for Worthen to exercise its options. Accordingly, although Frank Lyon Company could not realize a greater return, it could realize less. Furthermore, Frank Lyon Company retained the right to sell the building at any time.

[83] 308 U.S. 252. *See supra* text accompanying notes 76 and 77.
[84] 435 U.S. at 577.

Although the Court noted that "none of the parties . . . was the owner of the building in any simple sense . . .,"[85] it was Frank Lyon Company's capital that was committed to the building. Therefore, Frank Lyon Company acquired the benefits and burdens of ownership. Among the factors which the Court found to be significant were (1) the bona fide character of the negotiations resulting in the transaction, (2) the reasonableness of rental payments and option prices, (3) the presence of building depreciation risks on Frank Lyon Company, (4) Frank Lyon Company's risk that Worthen would default, (5) the fact that Worthen could walk away after the initial twenty-five-year lease term, (6) Frank Lyon Company's liability for ground rent even if Worthen did not exercise its option, and (7) the absense of any prior understanding that Worthen would exercise any of its options.

¶ 2203.3 Special Considerations Applicable to Qualified Pension Trusts and Real Estate Investment Trusts

As in the case of participating convertible loans, many of the ground lease and master lease transactions involve pension trusts and real estate investment trusts. Accordingly, it is also necessary in this context to analyze the special considerations affecting such entities. As a general matter, so long as a pension trust or real estate investment trust derives "rent from real property" such item, as the case may be, will not be subject to the tax on unrelated business income (unless the debt financed property rules apply) or will be counted toward the acceptable types of income necessary to maintain its status.

In general, sections 512(b)(3) and 856(d) are substantially similar. The major exception is that any tainted rent taints all rent for a pension trust, causing it to be taxed. However, in the case of a real estate investment trust, only the tainted portion of the rent is excluded. In addition, real estate investment trusts are treated more liberally with respect to rental from associated personal property and income from related services.

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[85] 435 U.S. at 581.

In the context of a qualified pension trust, rent from real property consists of several components. First, if the property at issue is real property for purposes of section 1250(c), such rent is acceptable.[86] Second, rent from real property also includes all rents from personal property (including certain specialized structures described in section 1245(a)(3)(B)) leased with such real property if, at the time such personal property is placed in service, its rental is only an incidental amount of the total rentals. Pursuant to Treasury Regulation section 1.512(b)–1(c)(ii)(b), as a general matter, such rents from personal property are not incidental if they exceed 10% of all rents from the property. If such 10% amount is exceeded, all of the rent from the personal property is included in the calculation of unrelated business income.

A number of exceptions to the foregoing rules apply. If the rents received with respect to personal property exceed 50% of the total rents, then none of the rent from the real or the personal property is excluded in calculating unrelated business income.[87] If the determination of any of the rents depends in whole or in part on the income or profits of any person derived from such property (other than a fixed percentage or percentages of gross receipts or sales), then none of the rent is excluded in calculating unrelated business income.[88] To determine whether rents depend upon net income or profits, reference is made to Treasury Regulation section 1.856–4(b)(3) and (6), other than Treasury Regulation section 1.856–4(b)(6)(ii), discussed below.[89] If rent becomes taxable, deductions with respect to such property are taken into account.

Where there are multiple leases of real and personal property, and where the use of such properties is integrated, all such leases will be considered as one lease.[90] In addition, payments with respect to hotels, motels, boarding houses, apart-

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[86] Treas. Reg. § 1.512(b)–1(c)(3)(i), T.D. 7177, 1972–1 C.B. 159, 160.

[87] I.R.C. § 512(b)(3)(B)(i) (1976).

[88] I.R.C. § 512(b)(3)(B)(ii) (1976).

[89] Treas. Reg. §§ 1.856–4(b)(3), (b)(6), T.D. 7767, 1981–1 C.B. 82.

[90] Treas. Reg. § 1.512(b)–1(c)(3)(iii), T.D. 7177, 1972–1 C.B. 159, 160.

ment hotels, tourist camps or homes, motor courts, parking lots, warehouses, or storage garages do not constitute rent from real property because of the extensive related services rendered to the occupant.[91] Services are considered rendered to the occupant if they are primarily for the occupant's convenience and are other than those usually rendered in connection with rentals. Maid service constitutes such service. However, furnishing heat and light, cleaning public areas, and collection of trash do not. In addition, payments for the occupancy of an entire residential unit or of offices in a building are generally considered rent.

As discussed above, section 856(d)(1) has a broader definition of rents from real property than that contained in section 512(b)(3)(A). Such term includes three components. The first component is rents from interests in property.[92] The second component is charges for services customarily provided in connection with such property, whether or not the charges for such services are separately stated.[93] Services to the tenants of a particular building will be considered customary if, in the geographic market in which the building is located, tenants in buildings of a similar class are customarily provided with such services.[94] Examples include furnishing utilities, cleaning public areas, performing janitorial services, and trash removal. The third component is rent attributable to personal property leased with such real property, but only if, in any taxable year, the rent attributable to the personal property does not exceed 15% of the total rent. Such rents are determined during the taxable year by looking at the average of the adjusted bases for the real and personal property at the beginning and end of the year.[95]

Three categories of receipts are excluded from the definition of rents from real property. The first exclusion applies to

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[91] Treas. Reg. § 1.512(b)-1(c)(5), T.D. 7632, 1979-2 C.B. 235.

[92] I.R.C. § 856(d)(1)(A) (1976).

[93] I.R.C. § 856 (d)(1)(B) (1976).

[94] Treas. Reg. § 1.856-4(b)(1), T.D. 7767, 1981-1 C.B. 82, 93.

[95] I.R.C. § 856(d)(1)(C) (1976).

any amount received directly or indirectly with respect to real or personal property, if it is based in whole or in part on the income or profits obtained by any person from such property (unless it is based exclusively on a fixed percentage or percentages or receipts for sales).[96] An exception to this exclusion exists if the real estate investment trust's rents are based on a fixed percentage or percentages of the tenant's receipts or sales, but the tenant's rents are based on the income or profits of one or more of its subtenants. In such latter case, only the tainted portion of the real estate investment trust's rents is excluded. The second exclusion applies to rents received directly or indirectly from certain related entities. The third exclusion applies to rents received from tenants, where the real estate investment trust provides services, or manages or operates the property, other than through an independent contractor.[97]

There are extensive rules on the permissibility of percentage rent. Thus, rents from real property includes rents based on different percentages of receipts from different departments of a retail store, so long as the percentage is fixed at the beginning of the lease and so long as no change in such percentage is negotiated that would have the effect of basing rents on income or profits.[98] In addition, receipts or sales may be adjusted for returned merchandise or for federal, state or local sales taxes.[99] Further, pursuant to Revenue Ruling 74–198,[100] adjustments may also be made to exclude exchanges of merchandise between the tenant's stores and for a tenant's sales of used fixtures. Other exclusions which are permitted in calculating percentage rent are escalation receipts, casualty insurance proceeds, and subtenants' security deposits. Escalation receipts include amounts received by a prime tenant from a subtenant, pursuant to an agreement to take into

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[96] I.R.C. § 856(d)(2)(A) (1976).

[97] I.R.C. § 856(d)(4) (1976).

[98] Treas. Reg. § 1.856–4(b)(3), T.D. 7767, 1981–1 C.B. 82, 93.

[99] *Id.*

[100] 1974–1 C.B. 171.

account all or any portion of increases in real estate taxes, property insurance premiums, and operating costs.[101]

If a lease provides for a fixed rental and a percentage rental based on a lessee's income or profits, and both are received in any year, then neither will qualify as rent from real property.[102] However, if only the fixed rental is received in any year and it is not based on income or profits, then it will so qualify. Two conditions must be satisfied in order for rentals based on one or more percentages of the lessee's receipts or sales in excess of a determinable amount to qualify as "rents" from real property. First, the determinable amount must not depend at all upon the lessee's income or profits. Second, the percentages and the determinable amount must be fixed when the lease is executed and cannot be renegotiated during the term of the lease so as to base rents on income or profits. In any event, if, considering the lease and all the surrounding circumstances, the arrangement does not conform to normal business practice but is merely an effort to base rent on income or profits, then such rent will not be treated as rent from real property.

Finally, the Service has held in a letter ruling that "escalation rent" based on a portion of the proceeds from a tenant's sale or refinancing of the improvements owned by the lessee, where a pension trust is the ground lessor, constitutes rent from real property for purposes of section 512(b)(3). [103] Moreover, in another letter ruling the Service held that the lessor's receipts are rents from real property where the lessor is entitled to receive a fixed minimum annual rental plus 10% of the lessee's receipts which exceed the prior year's minimum annual rental by $25,000, but not in excess of one-third of the lessee's cash flow.[104]

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[101] Treas. Reg. § 1.856–4(b)(3), T.D. 7767, 1981-1 C.B. 82, 93.

[102] *Id*

[103] Letter Ruling 8133051. Pursuant to I.R.C. § 6110, letter rulings lack precedential value.

[104] Letter Ruling 8008116.

¶ 2203.4 Tax Consequences if a Lease Is Recharacterized as a Financing Transaction

If a lease is recharacterized as a financing transaction, the lessor will be considered as a lender. Some of the lessor/lender's receipts will be interest income and the rest will be principal. This should not adversely affect a lessor/lender pension trust or real estate investment trust (assuming, in the case of the real estate investment trust, that the "lease" can be recharacterized as a mortgage). Further, as a result of such recharacterization of the transaction as a loan, a "lessor" of improvements will not be entitled to claim any cost recovery deductions; however, the payments attributable to principal will not be taxable to it.

From the perspective of the "lessee," some portion of the "rental" payments will no longer be deductible as rental, but will be treated as principal payments. The balance of the payments will be treated as interest expense. Further, the "lessee" will be considered as the owner of the improvements and will be entitled to cost recovery and amortization deductions. In any event, the chief difference between characterizing a transaction as a lease or as a financing transaction is one of timing of tax benefits and detriments, caused by shifting the cost recovery deductions from one party to another and converting into principal, which is never taxable, what was intended as a deductible/(non)taxable rental payment.

¶ 2203.5 Guidelines in Structuring a Lease

In structuring a ground lease or master lease, certain tax considerations should be taken into account. First, an option to purchase the property should be exercisable only at the fair market value of such property on the date of exercise. Second, the rental should also be based on the fair rental value of the property. Third, the lessor should retain the rights to (1) encumber its interest in the real property, (2) some or all of the profits from the property's sale, and (3) some or all of the proceeds from any casualty insurance or condemnation award. Fourth, the lessor should bear the burden of reasonable wear and tear; the lessor should make a capital investment in the property subject to the lease. Fifth, the intention of the parties should be clearly expressed in the documents. Sixth, contingent rent should be based on gross receipts or sales. Seventh, the risk of insolvency by the lessee should be borne by the lessor.

¶ 2204 ANALYSIS OF PARTNERSHIP PLANNING TECHNIQUES

¶ 2204.1 Guaranteed Payments vs. Priority Distributions

Three types of partnership tax planning techniques are relevant to this analysis. They include the use of guaranteed payments or priority distributions, the use of special allocation of bottom-line and above-the-line items, and selection of the cash versus accrual method of accounting.

In illustrating the advantages of guaranteed payments versus priority distributions, a hypothetical example is useful. Assume that a partner, such as a pension trust, can make an investment in a partnership either as a lender (*i.e.*, a loan) or as a partner (*i.e.*, a capital contribution). The return with respect to such an investment can be characterized as interest or as a priority distribution (*i.e.*, out of the first dollars of cash flow, such partner receives an amount equal to 10% of its unreturned investment). Whether a partner's investment is characterized as a loan or as a capital contribution and whether the return is interest or a priority distribution will have an effect on the timing of the partnership's deductions and the partner's income.

Under rules of partnership taxation, a payment by a partnership to a partner may be characterized in one of three ways. First, it can be characterized as a transaction between a partner and partnership, other than in such person's capacity as a partner.[105] Such characterization can apply to loans made to partners. Second, such payment can be characterized as a guaranteed payment to a partner for the use of capital or

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[105] I.R.C. § 707(a) (1976).

for services rendered in his capacity as a partner.[106] The chief limitations that apply in determining whether a payment constitutes a guaranteed payment are whether it is determined on the basis of the partnership's income and whether it is a capital expenditure. Third, such payment can be characterized as a payment to a partner in such person's capacity as a partner.

If an advance by a partner is treated as a loan, payment of interest to such partner is included in its income when accrued or received under the partner's method of accounting, regardless of the partnership's method of accounting. Further, even if the Tax Court's decision in *Pratt v. Commissioner*[107] is applied to treat interest on a loan from a partner to a partnership as a section 707(c) guaranteed payment, repayment of principal should be treated as a section 707(a) payment, *i.e.*, not taxable to the recipient.

If the interest payment is characterized as a guaranteed payment, it is a deduction from partnership income and may increase the partnership's loss. The interest payment must be included in the partner's income, as ordinary income for the partner's taxable year included in the partnership's taxable year when the interest payment is paid or accrued. This rule applies regardless of the partner's method of accounting.

If fixed interest on capital is treated as a section 707(c) payment, how will contingent interest be treated? Pursuant to *Pratt*, the court assumed that a management fee, stated as a percentage of gross rents, could not be a section 707(c) guaranteed payment, because it was based on partnership income. By analogy, a lender's participation in rents, cash flow, profits, etc., would not be classified as a section 707(c) guaranteed payment. However, in Revenue Ruling 81–300,[108] the Service announced that it will not follow this aspect of the *Pratt* case and will treat a comparable payment as a section 707(c) guar-

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106 I.R.C. § 707(c) (1976).

107 64 T.C. 203 (1975), *aff'd*, 550 F.2d 1023 (5th Cir. 1977).

108 1981–13 I.R.B. 32.

anteed payment. Query: Is a participation based on gross income a special allocation of income?[109]

If a partner has not made a loan to the partnership, but rather has contributed capital to it, and if the partner is entitled to the first dollars of partnership cash flow each year, not in excess of a specified percentage of capital (*e.g.*, 10%), such payment is neither a section 707(a) nor section 707(c) guaranteed payment, since it is neither made with respect to a loan nor is required to be made in any event. Rather, such payment is charged to capital and reduces the partner's basis in its partnership interest. Such partner will not necessarily be subject to tax at the time it receives such distribution. Such distribution will only be taxable if the amount of such cash distribution exceeds the partner's basis in its partnership in trust. Moreover, such payments are not necessarily ordinary income in the recipient partner's hands; such payments may qualify as capital gain.[110]

¶ 2204.2 Special Allocations of Bottom-Line and Above-the-Line Items

Pursuant to section 704(b), a partnership is permitted to allocate specially to one partner its income, gains, losses, deductions or credits, or items thereof, provided such allocation has substantial economic effect. Pursuant to Treasury Regulation section 1.704–1(b)(2) and the legislative history to the 1976 Tax Reform Act, a special allocation will have substantial economic effect if such allocation "may actually affect the dollar amount of the partners' shares of the total partnership income or loss independently of tax consequences."[111] In most instances, the validity of a special allocation is determined by whether it ultimately affects the partners' capital account balances and distributions with respect thereto. In any event, special allocations can improve the internal rates of return and the net present value of cash to the taxable partners.

[109] *See* I.R.C. § 704(c)(2) (1976).

[110] I.R.C. §§ 731, 733 (1976).

[111] For a general explanation of the Tax Reform Act of 1976, *See* H.R. REP. NO. 10612, 94th Cong., 1st Sess. (1976), 1976–3 (Vol. 2) C.B. 1, 107; H.R. REP. NO. 658, 94th Cong., 1st Sess. 125–27 (1975), 1976–3 (Vol. 2) C.B. 817–19; S. REP. NO. 938, 94th Cong., 2d Sess. 98–101, 1976–3 (Vol. 3) C.B. 136–39.

For our purposes, analysis of three types of special allocations is useful. The first is a special allocation of bottom-line loss, *i.e.*, the overall taxable loss of the partnership. Where the partnership consists of a taxable (*i.e.* , the developer) and non-taxable (*i.e.*, a qualified pension trust) partner, it is useful to allocate operating losses to the taxable partner. (Such special allocation of taxable loss away from the non-taxable partner may have a depressing effect on that partner's ability to market its partnership interest later.) If bottom-line loss is specially allocated to one partner, it is necessary to charge that partner's capital account by such amount, and, if such capital account is negative at the conclusion of the partnership, following all distributions, to require that partner to repay the amount of the negative balance. Such repayment is then distributed to the other partner to reduce the positive balance in his capital account.

The second type of special allocation is an allocation of a percentage of gross income. For example, one partner may be allocated 2% of the gross income of the partnership; thereafter, the partners share equally in partnership cash. If such an allocation of a percentage of gross income is charged to the distributee partner's capital account, and if there is an obligation to repay any negative balance in such partner's capital account at the conclusion of the partnership, such allocation should give rise to substantial economic effect. If, however, there is no obligation to repay any negative balance in such partner's capital account, then any such distributions creating such a negative balance will probably be treated as taxable upon receipt.

The third type of special allocation involves depreciation. Thus, it is possible to provide that the taxable income of the partnership, prior to taking depreciation into account, will be allocated in one manner and that all depreciation will be allocated entirely to one partner. Once again, such special allocation should reduce the capital account, to the extent thereof, of the partner who receives such special allocations. Further, such a special allocation should be conditioned upon (1) all gain from any disposition, but not in excess of such depreciation, being allocated to such partner and (2) such partner making up any negative balance in its capital account caused by such special allocation. One issue that arises is whether there can be substantial economic effect in the context of a special allocation of depreciation if the partner receiving the special allocation has a zero or negative capital account balance and the real estate's financing is non-recourse.[112]

¶ 2204.3 Use of the Cash or Accrual Method of Accounting

The third relevant tax planning technique is the judicious selection of the cash or accrual method of accounting. Pursuant to section 703(b), with exceptions not here relevant, a partnership can make all necessary elections to calculate its taxable income. Treasury Regulation section 1.703–1(b)(1) provides as an example of such elections, the choice of method of accounting. Section 446(c) allows a taxpayer to compute its taxable income under the cash receipts and disbursements method or under the accrual method. Under the cash receipts and disbursements method, all items constituting gross income (regardless of their form) are included in income in the year they are actually or constructively received, while expenditures are deducted in the year made.[113] Under the accrual method, income is included for the taxable year in which all the events have occurred which fix the right to receive such income and the amount can be determined with reasonable accuracy. Deductions are allowable for the taxable year in which all of the events have occurred which establish the fact of the liability for the payment and the amount can be determined with reasonable accuracy.[114]

These methods of accounting are useful depending upon the nature of the partnership's operations. For example, the cash method may not be useful to partnerships where interest ex-

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[112] Orrisch v. Commissioner, 55 T.C. 395 (1970) *aff'd per curiam*, Magaziner v. Commissioner, 37 T.C.M. (CCH) ¶ 35,193(M), at 873, 47 T.C.M. (P-H) ¶ 78,205, at 78–867 (1978).

[113] Treas. Reg. § 1.446–1(c)(1)(i) (1956).

[114] Treas. Reg. § 1.446–1(c)(1)(ii) (1956).

pense is important. In the case of interest expense, section 461(g)(1) provides that if a cash-method taxpayer prepays interest expense attributable to a period beyond the close of the taxable year, such prepayment must be capitalized and then treated as paid in the later period. Such rule even applies if the prepaid interest is non-refundable.[115] Further, the legislative history provides that, in the case of prepayments, section 461(g)(1) is intended to place cash-method taxpayers in the same position as accrual-method taxpayers.

Moreover, a cash-method taxpayer can only deduct interest if, in fact, it is paid. Thus, in *Battlestein v. Commissioner,*[116] a cash-method taxpayer was not allowed to deduct interest paid, where the lender then loaned back to the borrower an amount equal to such interest. This result should be compared to *Franklin v. Commissioner,*[117] allowing a taxpayer to deduct interest paid to banks participating in a loan where such interest was paid with funds borrowed from the lead bank.

On the other hand, if interest is an important expense item, the accrual method of accounting may be useful. Thus, relying on Revenue Ruling 68–643,[118] the Senate Report to section 461(g)(1) also provides that an accrual-method taxpayer can only deduct prepaid interest in the period in which the use of the money occurs and only to the extent of the interest cost of the borrowed funds for such period. Accordingly, interest accrues ratably over the period of the loan and is deductible regardless of when paid. Given this result, where a partnership adopts the accrual method of accounting, it may be eligible to deduct interest, whether or not it is actually paid.

It should be noted that in several letter rulings, the Service has disallowed the deduction by an accrual method limited partnership of interest with respect to a construction loan

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[115] Zidanic v. Commissioner, 79 T.C. 651 (1982).

[116] 631 F.2d 1182 (5th Cir. 1980).

[117] 82–2 U.S. Tax Cas. ¶ 9532 (5th Cir. 1982), *rev'g* 77 T.C. 173 (1981).

[118] 1968–2 C.B. 76.

used to build an apartment project. The Service based its disallowance on the argument that the accrual method did not clearly reflect the partnership's income; only the cash method would do so.[119]

In the case of planning for rental deductions, a cash method or accrual method partnership will generally be allowed to deduct rent in the same manner as it deducts interest. However, in *Zaninovich v. Commissioner*,[120] a cash-method taxpayer who made a rental payment on December 20, 1973, for the first year of a twenty-year lease, extending from December 1, 1973, to November 30, 1993, was entitled to fully deduct such payment in 1973. Rental payments covering a period not in excess of one year were held deductible. Thus, on the authority of *Zaninovich*, a cash-basis taxpayer that pays rent, for a period not exceeding one year, will be eligible to deduct such rent when paid. An accrual-method partnership, on the other hand, will only be allowed the deduction with respect to the ratable portion of the taxable year covered by such payment.

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[119] *See* Letter Ruling 8017007 and Letter Ruling 8017008, each issued on December 31, 1979.

[120] 616 F.2d 429 (9th Cir. 1980), *rev'g* 69 T.C. 605 (1978).