

Real Estate Partnerships and Joint Venture Agreements: Tax Challenges

Part I – Partnership/joint venture formation



Carey Smith
Carey.Smith@aporter.com
202.942.5538
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Part I Agenda

- Cash capital contributions
- Liabilities
- In-kind capital contributions
- Disguised sales
- Additional capital contributions and dilution provisions

Cash capital contributions

- Simplest possible fact pattern – partner contributes cash to partnership in exchange for a partnership interest
- No recognition of income to contributing partner or to the partnership.
- Partner's initial tax basis for its partnership interest is equal to the amount of cash contributed.
- Partner's holding period begins on date of acquisition of partnership interest.
 - If partner contributes cash on multiple dates, holding period for partnership interest will be calculated separately with respect to each contribution.

Cash capital contributions (continued)

- Example. A is a 50% partner in AB partnership. Each of A and B contributes \$100 cash (total of \$200) on January 1, 2011 in consideration for their interests. On January 1, 2012, AB requires additional cash in amount of \$100, and each of A and B contributes additional \$50 cash to AB.
- On September 1, 2012, A sells its entire partnership interest to C for \$400 cash. Assuming no intervening allocations or distributions, we know that A's tax basis is \$150, so A has taxable gain on the sale of \$250 (capital gain, assuming no special rules). Is this long-term or short-term capital gain?
- Answer depends on the value of A's partnership interest as of 1/1/12. A has to bifurcate interest into two pieces, the part held since 1/1/11 which generates long-term capital gain and the part acquired on 1/1/12 which generates short-term capital gain.

Cash capital contributions (continued)

- Partner receives capital account credit equal to the amount of cash contributed. Immediately on the initial formation/contribution of cash, for that moment in time, partner's capital account equals partner's tax basis (and also equals FMV of partnership interest).

Liabilities

- In general, when a liability shifts between a partnership and a partner, that is treated for tax purposes the same as a transfer of cash between those parties.
- So if partner assumes the liability of a partnership, that is treated the same as if the partner had contributed cash to the partnership in the amount of the assumed liability.

Liabilities (continued)

- Usually in real estate context, the liability assumption is moving in the other direction, because a partner is contributing property to a partnership and the partnership is assuming the partner's liability.
- Alternatively, partnership accepts property that is subject to a liability (such as real property that is subject to a recorded mortgage or deed of trust).
- These are treated generally the same for tax purposes, as a cash distribution from the partnership to a partner.

Liabilities (continued)

- Section 752 establishes detailed rules to allocate a partnership's liabilities among its partners. If a partnership liability is allocated to a partner, that is also generally treated for tax purposes as a contribution of cash by that partner to the partnership. If a partnership liability shifts away from a partner to another partner, or is paid by the partnership, that is generally treated as a distribution of cash by the partnership to the first partner.
- In real estate JVs, there is often significant attention paid to the Section 752 allocation of liabilities.

Liabilities (continued)

- Example. A owns real property having a value of \$1,000 and a tax basis of \$0, which is subject to a customary non-recourse mortgage loan of \$200. A contributes the property to a 50/50 partnership with B, AB partnership, with B contributing \$1,000 of cash to be used by AB to improve the property. The mortgage loan will stay in place and be assumed by AB.
- The \$200 loan is becoming a partnership liability and has to be allocated between A and B under Section 752. In the absence of other facts, the loan would generally be allocated 50/50, so \$100 of the liability is allocated to A and \$100 to B. From A's perspective, this will generate \$100 of taxable gain (net deemed distribution of \$100 in excess of A's basis).
- If A is willing to bear the economic risk of loss for the entire \$200 loan, e.g. by guaranteeing the entire loan without right to seek contribution from B, then A would not have any net deemed distribution and thus no immediate taxable gain.

In-kind contributions

- Section 721 provides a basic rule of nonrecognition of gain or loss for a contribution of “property” in exchange for a partnership interest.
- Unlike with corporations under Section 351, there is no “control” requirement.
- The definition of “property” is construed fairly broadly, but it excludes services. Some contributions may be difficult to distinguish between property and services.
 - Example. A spends several months pursuing a real property acquisition, eventually signing a purchase agreement. A assigns the purchase agreement to a new partnership AB, receiving capital account credit of \$100 to reflect the FMV of the purchase agreement.
 - This is probably treated properly for tax purposes as a contribution of property and not services, but that is not entirely clear, and there are many factual questions that could change the analysis.

In-kind contributions (continued)

- Real estate sponsors, developers, managers generally do not want to be treated as receiving a “capital interest” in a partnership in exchange for services.
- Any partnership interest can be classified as a “capital interest” or a “profits interest” on the date that it is issued to a partner.
- A “profits interest” is defined as a partnership interest that has a value of zero based on an immediate hypothetical liquidation. If a partner receives solely a profits interest, then on the date interest is issued, that partner’s capital account value is zero. (Profits interest often referred to in non-tax terms as carry, promote, or carried interest.)
- A “capital interest” is anything else (value greater than zero based on immediate hypothetical liquidation).

In-kind contributions (continued)

- A person receiving a capital interest in exchange for an in-kind contribution of services, is taxed immediately on receipt of the interest, based on the fair market value of the partnership interest received. (Under proposed guidance, parties may use immediate-hypothetical-liquidation value as proxy for FMV.) It is rare for taxpayers to voluntarily bargain for this tax treatment.
- A person receiving a profits interest in exchange for an in-kind contribution of services, is **not** taxed immediately on receipt of the interest.

In-kind contributions (continued)

- Back to simpler case – a clear contribution of property to partnership in exchange for a partnership interest.
- Tax basis
 - Partner's initial basis in partnership interest is its basis in the contributed property.
 - Partnership takes a carryover basis in the contributed property.
- Built-in gain (or loss)
 - Often the FMV of contributed property (as negotiated by the contributing and other partners) is not equal to the tax basis of the property. The difference is built-in gain (or loss).
 - Built-in gain (or loss) is addressed under Section 704(c) and extensive regulations thereunder.

In-kind contributions (continued)

- Holding period
 - So long as the contributed property is a capital asset in hands of the contributing partner, that partner will have a “tacked” holding period in its partnership interest – treated as if partner had held the partnership interest for the period beginning on acquisition by partner of the contributed property.
 - Partnership similarly takes a tacked holding period in the contributed property.
- Contributing partner receives capital account credit equal to the FMV of the contributed property

In-kind contributions (continued)

- Focusing on capital accounts – at any given time, a partner's capital account reflects the net value of that partner's interest in the assets of the partnership
- Capital account (as we use that term) does not necessarily reflect:
 - Fair market value
 - Tax basis
 - GAAP accounting
- Some partnerships maintain and report capital accounts on a tax basis; these are not really capital accounts
- For our vocabulary, a capital account has to be maintained in accordance with the Treasury Regulations under Sec. 704(b)

In-kind contributions (continued)

- Basic Capital Account Maintenance
- A partner's capital account is increased by:
 - Money contributed to the partnership
 - The fair market value of property contributed, net of any liabilities
 - Allocations of partnership income and gain
- A partner's capital account is decreased by:
 - Partnership distributions of money
 - The fair market value of property distributed, net of any liabilities
 - Expenditures that are nondeductible under Section 705(a)(2)(B) or are syndication costs
 - Allocations of partnership deductions and losses

In-kind contributions (continued)

- Best practice is for partnership to maintain capital accounts in accordance with Treasury Regulations
- The defined term “Capital Account” can sometimes be used in JV agreement provisions in ways that are confusing or inaccurate. Need to understand whether capital accounts will always be consistent with the business deal, or whether there can be circumstances where capital accounts are not proportionate to real ownership interests based on the detailed capital account maintenance rules.
- If there is any risk of confusion or inaccuracy, best practice is not to allow the economic provisions (e.g. right to receive distributions) key off of capital accounts.
- Alternatively, if it is important for economic provisions to be driven by the capital accounts, there is a premium on accurate drafting and implementation of provisions relating to allocations and other maintenance of capital accounts.

Disguised sales

- We have been discussing formation of a partnership. Base case is that 2 or more partners come together to form a new entity (partnership or LLC for state law purposes), and each contributes cash, services, and/or other property in exchange for interests in that entity.
- Under that base case, federal income tax treatment matches state law treatment.
- In many cases, particularly in the world of formation of a partnership, the federal income tax treatment is different than the state law treatment.

Disguised sales (continued)

- Many examples of this disconnect result from the fact that a state-law entity (often an LLC) can be disregarded for federal income tax purposes.
 - In the absence of a check-the-box election, an eligible entity such as a domestic LLC is disregarded for federal income tax purposes if it has only one owner.
 - Example. A forms LLC1, contributes cash, services or other property to LLC1 in exchange for 100% of the interests in LLC1. Although this is a “formation” of LLC1 for state law purposes, it is a non-event for federal income tax purposes.
 - Continuing the example. If B later contributes cash, services or other property to LLC1 in exchange for an interest in LLC1 (could be 1% or 50% or anything else), that event causes the formation of a partnership for federal income tax purposes, even though there is no new entity being formed for state law purposes.

Disguised sales (continued)

- The disguised sale rules provide additional examples where a transaction is treated differently for state law purposes (or just in the documents) and for federal income tax purposes.
- General rule – if the disguised sale rules apply, a purported contribution of property may be treated in whole or in part as a sale of the property to the partnership in exchange for the transfer by the partnership to the purported contributor of cash or other consideration.

Disguised sales (continued)

- Example. A and B form AB Partnership. A contributes property X having a value of \$500 and tax basis of \$300, and B contributes \$250 cash. Immediately thereafter, AB distributes \$250 cash to A. After these transactions, A and B each have a \$250 capital account and a 50% interest in AB.
- If form is respected, A would not have any taxable gain.
- Form will not be respected! A is really contributing half the property and selling the other half. A must allocate its \$300 basis between those two halves, and A is treated as contributing a property with \$250 FMV and \$150 basis, and selling a different property for \$250 cash with a \$150 basis (recognizing \$100 of immediate taxable gain).

Disguised sales (continued)

- Determination of disguised sale is based on all facts and circumstances. The regulations list many factors that may be relevant, but the key factors are:
 - Is there a transfer of property from contributing partner to partnership;
 - Is there a transfer of money or other consideration by the partnership to the contributing partner;
 - Are those 2 transfers related such that the second transfer would not be made but for the first; and is the second transfer dependent on the entrepreneurial risks of partnership operations.

Disguised sales (continued)

- Presumptions under disguised sale rules
 - Transfers made by the partnership more than two years before or after the purported contribution (favorable presumption)
 - Transfers made by the partnership within two years of the purported contribution (unfavorable presumption).
 - Example. Partner A transfers undeveloped unencumbered land with a built-in gain of \$500 (FMV of \$1,000 and adjusted tax basis of \$500) to AB Partnership. AB intends to develop the land by constructing a building on it, and AB's partnership agreement provides that upon completion of construction AB will distribute \$900 to A. If within 2 years of A's contributing the building is completed and AB makes a distribution to A pursuant to the partnership agreement, such distribution will be presumed a disguised sale of part of the land by A unless rebutted.

Disguised sales (continued)

- Exceptions to disguised sales. There are several exceptions in the regulations that are specifically **not** treated as disguised sales. Among the more interesting exceptions for planning with real estate joint ventures:
 - Reimbursement of pre-formation capital expenditures
 - Permits transfer by partnership to reimburse partner for capital expenditures (1) incurred during 2-year period prior to property contribution and (2) incurred with respect to the contributed property (or partnership organization and syndication costs)
 - Reimbursement cannot exceed 20% of FMV of the property at the time of contribution. However, that 20% limit does not apply if the FMV of contributed property does not exceed 120% of the partner's tax basis in the contributed property at the time of contribution.

Disguised sales (continued)

- Exceptions to disguised sales (continued).
 - Debt-financed distributions
 - Partnership may transfer proceeds of a partnership liability (i.e. the amount borrowed) to a partner, and this is not treated as a disguised sale if the partner receiving the distribution is allocated 100% of the partnership liability under the liability allocation rules of Section 752.
 - The debt financed distribution exception was the subject of the recent, and heavily criticized, case: Canal Corporation, 135 TC No. 9. In that case, the Tax Court held that the debt-financed distribution exception did not apply, invoked the partnership anti-abuse rule to disregard an indemnity agreement entered into by the recipient of the debt-financed distribution, and held that the recipient did not bear the economic risk of the partnership's liability. The Tax Court further held that a "should" level tax opinion obtained from PwC did not provide the recipient with a good faith and reasonable basis defense against a substantial understatement penalty. For the Court, a key fact was that the provider of the indemnity did not have assets equal in value to the amount of the indemnity.

Additional capital contributions and dilution provisions

- The admission of a new partner or the contribution of additional capital by some but not all existing partners can lead to dilution of the other partners' interests. It can also lead to potential tax issues.
- If a partnership has built-in gain in its property at the time a new partner is admitted, it is generally advisable to “book up” or revalue the original partners’ capital accounts to fair market value. This allows the preadmission appreciation to be allocated solely to the original partners (both economically, and for tax purposes based on Section 704(c) principles)

Additional capital contributions and dilution provisions

- Dilution provisions. If one or more partners fail to contribute required capital contributions, a partnership agreement may call for adjustments in the partners' interests. Often these include "penalty" dilution.
- These provisions sometimes are ambiguous or contradict the allocation or distribution provisions, where the latter provisions assume that percentage interests will not change at any time during the partnership's life. Consider whether there is a need to address changes in capital accounts that will match (or follow) the changes in percentage interests resulting from the dilution provisions.