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Equity Participation Arrangements between Institutional Lenders and Real Estate Developers Symposium - Real Estate Finance - An Emphasis on Texas Law.

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EQUITY PARTICIPATION ARRANGEMENTS BETWEEN INSTITUTIONAL LENDERS AND REAL ESTATE DEVELOPERS

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I. Introduction 931
A. Equity Participations in General 934
1. Types of Projects Involved 934
2. Types of Participants Involved 934
3. Role of the Developer 934
4. Role of the Lender 935
B. Objectives of the Parties 935
1. General Objectives 935
2. Principal Areas of Conflict 936
3. Designing an Appropriate Structure 936
C. Scope and Objectives of Article 937
1. Arrangements to be Analyzed 937
2. Objectives of Article 937
II. Preliminary Considerations 937
A. Authority to Engage in the Transaction 938
1. Developer's Authority 938
2. Lender's Authority 938
B. Usury Considerations 940
III. Choice of Project Entity 942
A. Use of Corporation 942
1. Tax Considerations 942
2. Liability Considerations 945
3. Control Considerations 946
4. Effect on Mortgage Financing 948
5. Effect on Title Insurance 949

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St. Mary's Law Journal, Vol. 12 [1980], No. 4, Art. 4

6. Effect on Admitting Investors 950
7. Summary of Considerations 951
B. Use of a Limited Partnership 951
1. Tax Considerations 951
a. Continuity of Life 952
b. Centralization of Management 952
c. Free Transferability of Interests 954
d. Limited Liability 955
2. Liability Considerations 956
3. Control Considerations 960
4. Effect on Mortgage Financing 961
5. Effect on Title Insurance 962
6. Effect on Admitting Investors 963
7. Summary of Considerations 964
C. Use of a Co-Tenancy 965
1. Tax Considerations 965
2. Liability Considerations 965
3. Control Considerations 966
4. Effect on Mortgage Financing 966
5. Effect on Title Insurance 968
6. Effect on Admitting Investors 969
7. Summary of Considerations 970
D. Use of a Joint Venture 970
1. Tax Considerations 970
2. Liability Considerations 971
3. Control Considerations 973
4. Effect on Mortgage Financing 974
5. Effect on Title Insurance 975
6. Effect on Admitting Investors 976
7. Summary of Considerations 976
IV. Choice of Ownership Arrangement in Project Entity 977
A. Choice of Ownership Arrangements by Lenders 977
1. Tax Considerations 977
2. Liability Considerations 979
3. Effect on Mortgage Financing 979
4. Summary of Considerations 980
B. Choice of Ownership Arrangements by Developers 980
1. Tax Considerations 981
2. Liability Considerations 984

Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

3. Control Considerations 987
4. Summary of Considerations 988
V. Analysis of Individual Equity Participation Arrangements 988
A. General Considerations 989
1. Tax Considerations 989
2. Liability Considerations 989
3. Control Considerations 990
4. Effect on Mortgage Financing 991
5. Summary of Considerations 992
B. Analysis of Initial Ownership Arrangement 993
1. Determining Ownership Percentages and Debt/Equity Ratio 993
2. Capital Contribution Responsibilities 993
3. Construction Financing and Construction Period Losses 996
4. Obtaining Replacement Financing 1000
5. Initial Compensation to Developer 1003
6. Handling Cost Overruns 1006
7. Distribution of Operating Net Cash Flow. 1007
8. Responsibility for Operating Deficits 1008
9. Allocation of Operating Income and Losses 1010
10. Distribution of Sale Proceeds 1011
11. Allocation of Gain and Loss on Sale 1015
C. Analysis of Convertible Mortgage Arrangement 1016
1. Operations Prior to Conversion 1017
2. Tax Effects of Conversion 1019
3. Operations After Conversion 1022
D. Analysis of Purchase Option Arrangement 1023
1. Operations Prior to Exercise of Option ... 1023
2. Tax Effects of Exercising Option 1023
3. Operations After Option is Exercised 1025
VI. Conclusion 1025

I. Introduction

The experience of institutional lenders with inflation during the closing years of the 1970's has resulted in the almost total disappearance of what was once considered to be the conventional method of financing commercial real estate projects. The number of lenders who were willing to make conventional, long-term, per-

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manent mortgage loans bearing fixed interest rates and providing for level amortization of principal and interest until maturity diminished severely during the recession of 1974-1975. The hyperinflation which the United States has experienced during the last several years has furthered that process. Regardless of the interest rate fixed in the loan documents, the increasing pace of inflation has made it seem unwise to commit money for a long period of time to one project when the opportunity would almost certainly become available in a relatively short period of time to invest that same money in an alternative form at a higher return.[1] More importantly, the pace of inflation has become such that lenders increasingly have experienced negative rates of return on their investment in conventional mortgage loans.[2]

Lenders have been utilizing various alternative financing methods in an attempt to counteract the effect of inflation on their loans. One widely used method involves imposing a shorter maturity on the loan. Typically, such a loan provides for amortization based on a thirty-year term, with the loan being due or callable by the lender at the end of ten or fifteen years. Recent loans of this type involve even shorter maturities. Another method involves the "due on sale" clause, used by lenders to impose a new interest rate reflecting current market conditions at the time a project is sold. During and after the 1974-1975 recession, many lenders obtained a nonownership participation in the revenues of various projects.[3] Under such a transaction, the lender receives additional interest on the loan which is based on a percentage of the project's revenues, calculated with respect to either all of the revenues of the project

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1. *See generally* Strum, *Today's Real Estate Financing Climate—Some of the Causes and Some of the Problems*, 13 REAL PROP., PROB. & TR. J. 757 (1978).

2. For example, if a lender wished to achieve a real return of 2% per annum on its invested funds, it would be able to do so at an interest rate of 8% if the inflation rate averaged 6% per annum. A portion of the interest would offset the reduction in value of the principal of the loan, and the balance of the interest would represent a real return to the lender on its investment. If, however, the inflation rate were to increase to 11% per annum, the lender would realize a negative return of 3% on an 8% loan, because the interest would cover only a portion of the loss in value of the principal of the mortgage, and the value of the principal would have been reduced by 3% each year.

3. *See generally* Strum, *Today's Real Estate Financing Climate—Some of the Causes and Some of the Problems*, 13 REAL PROP., PROB. & TR. J. 757 (1978). *See also* Kuklin, *Real Estate Financing And The World We (Will) Live In*, 13 REAL PROP., PROB. & TR. J. 1116 (1978); Nosari & Lewis, *How Usury Laws Affect Real Estate Development*, 9 REAL EST. L.J. 30 (1980).

Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

or, typically, the increased revenues of the project above an agreed level. Lenders are currently experimenting with various types of variable interest provisions, where the interest on the loan is not fixed at a specified rate but fluctuates (either freely or within prescribed parameters) to reflect changing market conditions.[4] Another technique currently being considered by some lenders is the shared-appreciation mortgage, where the lender receives additional interest calculated as a percentage of the project's enhancement in value either at the time of sale or refinancing of the project or at stated intervals.[5] In the past several years, some lenders have acquired all of the ownership interest in projects to which they commit funds, by purchasing the entire project from a developer and hiring local firms on a contract basis to provide necessarily local property management services. Yet another method employed by lenders attempting to counteract inflation is to own a portion, but not all, of the ownership interest in projects financed with their funds. It is this last technique, where lenders own an equity interest in real estate projects in participation with the developer, that is the concern of this article.

The use of equity participations by lenders as a means of counteracting inflation has materially affected, sometimes adversely, the usual methods of structuring real estate projects. For example, it is difficult in such a situation to structure a project in a manner which utilizes capital raised from individual investors through private placements of interests in the project if a lender is insisting on owning a large percentage of the equity ownership. More dramatically, developers have seen their traditional independence eroded significantly by the large management role which many lenders insist on having as an integral part of their equity participation in the project. This article describes various aspects of the struggle between the lender and developer to reach an agreement regarding the roles which each of them will play in the development, financing, construction, ownership, operation, and sale of the project in which they are participating jointly.

4. Boykin & Philips, *The New Challenger: The Variable-Rate Mortgage*, 8 REAL EST. REV. 83 (1979).

5. *See* Hayes, *Architects of Exotic Mortgages*, FORTUNE, Dec. 29, 1980, at 66-70.

A. *Equity Participations in General*

1. *Types of Projects Involved.* An equity participation arrangement generally can be used for almost any type of real estate venture. The project may be developed to be held for rental purposes, for immediate sale as a complete entity, or for sale as condominium units. The exact type of project, as well as the developmental objectives of the parties, may affect certain decisions made by the parties and the related advice provided by their counsel. Unless otherwise noted, this article focuses on certain factors which should be considered in structuring an equity participation arrangement for a typical garden apartment complex or office building held by the parties for rental purposes.

2. *Types of Participants Involved.* The role of the developer in an equity participation arrangement can be performed by any type of corporation or partnership, by an individual, or by various other types of entities.[6] The role of the participating lender in an equity participation arrangement can be performed by the same variety of institutions and entities which typically have provided conventional mortgage financing for real estate projects. This article addresses the types of arrangements which both the lender and developer may select to own their respective beneficial interests and attempts to call attention to some of the major considerations which will need to be taken into account by the parties when the lender desires to extend its role from that of the typical mortgage lender to that of a participant in an equity participation arrangement.

3. *Role of the Developer.* Activities which typically characterize the role of the developer are: (1) to conceive the idea of the project; (2) to supervise and coordinate the necessary legal, accounting, architectural, and other services involved in the development, construction, and operation of the project; (3) to arrange for the purchase or lease of the land; (4) to supervise the construction of the improvements; and (5) to supervise the leasing and operation of the project after completion. In addition, the developer may be required to commit its own funds to the project. Notwithstanding economic considerations, the lender may simply want the assur-

6. Unless otherwise noted, the text assumes that the developer is a regular business corporation.

ance that the developer has enough confidence in the project to commit its own funds to the project. In any case, the lender is willing to become involved in the equity participation arrangement with the developer because the developer is considered to be better able, through experience and expertise, to handle these matters than the lender would be directly.

4. *Role of the Lender.* The lender's role is to provide all or a substantial part of the financing required for the development and construction of the project. Such financing may take the form of loans or equity contributions, or a combination thereof. Most lenders will also bring a degree of expertise to the development and operation of the project, based on wide experience with various types of similar projects. For example, such expertise would include the ability to advise the developer regarding project location, design, and rental levels in order to achieve maximum marketing exposure and success and to assist in evaluating subcontractors' bids.

B. *Objectives of the Parties*

1. *General Objectives.* Developers and lenders exploring the possibility of entering into an equity participation arrangement share a mutual objective of pooling their efforts and resources for the purpose of obtaining the maximum return on their investment of money and time. Each party, however, customarily approaches that mutual objective from a different perspective. The developer comes from an entrepreneurial tradition, where independence is considered essential and risk-taking is an accepted price to pay for the possibility of substantial financial rewards. On the other hand, the lender comes from an institutional background, where collective and careful review are considered essential and a moderate rate of return is an accepted price to pay for minimizing the degree of risk threatening the lender's principal.[7] Each party must negotiate a path from its separate starting point to an agreeable accommodation as to the manner in which they jointly will engage in the proposed project. Therefore, in the course of negotiating, each

7. *See generally* Hartman, *Economics Make Strange Bedfellows: The Institutional Joint Venture*, 2 Real Est. Rev. 62 (1972). As noted in the text accompanying notes 23-25 *infra*, usury considerations make it particularly important for the lender to assess its position with respect to risk.

St. Mary's Law Journal, Vol. 12 [1980], No. 4, Art. 4

party must move closer to the tradition of the other party in order to reach a satisfactory agreement and achieve their mutual objective of obtaining the maximum return on their investment.

2. *Principal Areas of Conflict.* The separate traditions of the developer and lender usually result in the need for resolving a number of individual business issues in the course of negotiating the ultimate form of their agreement. Among the more important areas of potential conflict are: (1) the type of equity participation arrangement to be utilized; (2) the ownership interests of the parties; (3) the extent to which the financial commitments of the parties, especially the lender's, will be treated as debt or equity, or some combination thereof; (4) the relative obligations of the parties to provide financing at particular stages of the project; (5) the lender's obligation to loan the developer any funds which the developer is required to contribute to the project; (6) the degree to which the return to the parties on their respective investments will be guaranteed, cumulative, or simply preferential; (7) the control each of the parties will have over various aspects of the development and operation of the project; and (8) the extent, if any, to which the parties will be restricted from engaging separately in competing activities. While some of these areas of potential conflict are beyond the scope of this article, significant areas of potential conflict and various ways in which such conflicts can be resolved are discussed in detail below.[8]

3. *Designing an Appropriate Structure.* In addition to solving their basic business conflicts, the parties must decide what kind of legal structure will be utilized for their agreed arrangement. This decision is two-pronged. First, the type of entity or structure utilized for the ownership of the project must be established. Second, the type of ownership arrangement used by each party for holding its interest in the project must be determined. Individual ownership arrangements may be the result of basic business agreements of the parties. More often, however, they are premised upon individual considerations which are not necessarily affected by the business agreements of the parties. Selecting the appropriate struc-

8. For a different perspective on the potential conflicts involved, and some of the legal issues which arise in connection therewith, see Subcommittee on Debtor-Creditor Problems of Real Estate Financing Committee, *Report: Equity And Debt Participation—Possible Conflict of Duties*, 9 REAL PROP., PROB. & TR. J. 509 (1974).

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Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

ture, therefore, may be done before, during, or after the parties have resolved the major business aspects of their agreement.

C. *Scope and Objectives of Article*

1. *Arrangements to be Analyzed.* Three major types of equity participation arrangements are discussed in this article. The first type is referred to as the initial ownership arrangement, in which the developer and lender join together to own the project at or before the commencement of construction. The second type is referred to as the convertible mortgage arrangement, in which the lender does not own any interest in the project initially but has a right to convert all or part of its mortgage loan into an ownership interest at some time in the future. The third type is referred to as the purchase option arrangement, in which the lender does not own an interest in the project initially but has a future right to purchase an ownership interest in the project for additional consideration. The convertible mortgage arrangement and the purchase option arrangement share many similarities, as they both involve the future exercise by the lender of a right to acquire an ownership interest in the project. The result of the lender exercising this right is the formation of an equity participation arrangement. Consequently, many of the considerations that must be taken into account in developing the structure for an initial ownership arrangement must also be taken into account in reaching an agreement on the structure of an equity participation arrangement which the parties will utilize if the lender exercises its rights under a convertible mortgage or purchase option arrangement.

2. *Objectives of Article.* This article has three basic objectives. The first objective is to identify certain factors which must be considered in choosing the form of entity or structure to own the project. The second objective is to set out certain factors which must be considered in choosing the ownership arrangement which each of the parties will utilize to own its interest in the project. The third objective is to identify certain factors which must be taken into account by the parties in negotiating various aspects of their proposed equity participation arrangement.

II. Preliminary Considerations

Certain threshold issues must be addressed and resolved by the

St. Mary's Law Journal, Vol. 12 [1980], No. 4, Art. 4

lender and developer before the decision is made to pursue an equity participation arrangement. Obviously, fundamental business considerations, such as the potential return on the resources committed to a proposed investment and the risk of loss associated therewith, should be considered and analyzed prior to making substantial commitments of time and funds. The parties and their counsel should also examine certain fundamental legal issues in the formative stages of the transaction. Two important issues are: (1) whether either party's authority to participate in the proposed transaction is subject to restrictions; and (2) whether the transaction, if recast as a loan, is usurious.

A. *Authority to Engage in the Transaction*

1. *Developer's Authority.* The only significant restrictions on the typical developer's authority or capacity to engage in an equity participation arrangement are those imposed by the documents, if any, governing the developer's existence and operations.[9] When the developer is a corporation or a partnership, a careful review of the corporate documents or partnership agreement should be undertaken in order to make any required amendments or additions. This is a relatively simple procedure necessary to insure the authority of the developer to participate in the proposed project. During the formative state, the developer's counsel should also address any other matters deemed necessary to render an opinion to the lender regarding the authority of the developer to enter into the transaction.[10]

2. *Lender's Authority.* Institutional lenders are subject to a

9. *See* TEX. BUS. CORP. ACT ANN. arts. 2.01-.02 (Vernon 1980) (sets out purposes and powers of a corporation); TEX. REV. CIV. STAT. ANN. art. 6132b, §§ 2, 6 (Vernon 1970) (sets out definition of a partnership). *See also* TEX. REV. CIV. STAT. ANN. art. 1302-2.06 (Vernon 1980) (relates to consideration for indebtedness and authority to make a guarantee, both of which should be considered).

10. In Texas, this would include, among other things, verifying the corporation's authority to do business and good standing with the Secretary of State and the Comptroller of Public Accounts, and determining any actions which may be necessary to be accomplished by the board of directors. The authority and capacity of the partners of a partnershp to engage in the transaction should be verified. While it would not affect the corporation's, partnership's, or individual's capacity or authority to enter into the transaction, counsel also should verify that the assumed name statutes have been complied with to avoid future problems in that area. *See* TEX. BUS. & COM. CODE ANN. §§ 36.01-.26 (Vernon Supp. 1980-1981).

Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

myriad of legislative and regulatory restrictions, which may directly or indirectly affect the lender's authority to engage in an equity participation arrangement.[11] These controls and restrictions may also affect collateral issues, such as the negotiating position of the lender and the operation of the project after it is completed. For example, national banks may own only such real property as is necessary for "its accomodations in the transaction of its business."[12] Insurance companies may not own residential real estate in Texas and are subject to other restrictions which may affect the timing of their participation in an equity participation arrangement involving undeveloped property that ultimately will be developed for non-residential use.[13] Additionally, lenders subject to the Employee Retirement Income Security Act of 1974 (ERISA),[14] must take into account ERISA's provisions regarding "prohibited transactions"[15] and fiduciary standards.[16]

Considerations collateral to the imposition of restrictions and control may affect both the structure of the proposed transaction and the parties' negotiating positions. For example, a bank may attempt to structure the transaction in a manner that will allow it to utilize the credit for ad valorem taxes assessed on bank real property against taxes imposed on bank stock.[17] Lenders, subject

11. *See generally* Hartman, *Economics Makes Strange Bedfellows: The Institutional Joint Venture*, 2 REAL EST. REV. 62 (1972); Roegge, Talbot & Zinman, *Real Estate Equity Investments And The Institutional Lender: Nothing Ventured, Nothing Gained*, 39 FORDHAM L. REV. 579 (1971).

12. 12 U.S.C. § 29 (1945). There also are restrictions on the amount that may be invested. *See id.* § 3371d (Supp. 1980).

13. TEX. INS. CODE ANN. art. 3.40-1(1) (Vernon Supp. 1980-1981). It should be noted that at the time of this writing a bill has been introduced in the Texas Legislature that would allow insurance companies to own residential real property containing ten or more living units. (House Bill 870).

14. Pub. L. No. 93-406, 88 Stat. 829 (1974).

15. *See* 29 U.S.C. §§ 1106, 1107 (1975) (Pub. L. No. 93-406, §§ 406-407, 88 Stat. 832 (1974)). *See generally* Kanner, *Financing Ideas—Pension Fund Investment in Real Estate*, 8 REAL EST. L.J. 343, 347 (1980). The corresponding provisions of the Internal Revenue Code are codified at I.R.C. § 4975. The problems that accompany violation of the prohibited transaction provision include potential civil liability and assessment of excise taxes. For a detailed discussion of the prohibited transaction and fidiciary responsibility areas, see Lee, *(ERISA)—Fiduciary Responsibilities and Prohibited Transactions*, [1975] TAX MNGM'T (BNA) 308.

16. *See* 29 U.S.C. §§ 1101-1114 (1975) (Pub. L. No. 93-406, §§ 401, 411, 88 Stat. 832 (1974)).

17. TEX. REV. CIV. STAT. ANN. art. 7166 (Vernon 1960). While it is not clear that such a technique would be successful for the stated purpose, a bank may desire to retain title to

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to ERISA's broad range of prohibited transactions provisions, must constantly monitor projects in which they are involved, particularly with respect to the relationships between the parties, their affiliates, and lessees of the project.[18] Lenders which are otherwise tax-exempt will need to determine the extent to which their participation in the project will give rise to taxable income.[19] Further, corporate lenders considering acquisition of an interest through a subsidiary should consider the availability of the consolidated return provisions of the Internal Revenue Code (Code).[20]

B. *Usury Considerations*

Unfortunately, usury questions in equity participation arrangements are often overlooked until one of the following circumstances arises: (1) the developer defaults on some obligation within the parties' agreement and searches for a defense to its liability; or (2) counsel for the developer or lender is required, usually at closing, to deliver an opinion letter as to whether the transaction could be deemed a usurious loan. While a complete analysis of the usury issue within equity participation arrangements is beyond the scope of this article, pertinent factors which should be considered are ad-

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the real property upon which the proposed project is to be located and enter into a long-term lease arrangement with the entity developing the property; such entity would include the bank as a participant. The bank would also be a major tenant of the project. *But see* City of Midland v. Midland Nat'l Bank, 607 S.W.2d 303, 304 (Tex. Civ. App.—El Paso, 1980, writ filed).

18. *See generally* Lee, *(ERISA)—Fiduciary Responsibilities and Prohibited Transactions*, [1975] TAX MNGM'T (BNA) 308. The breadth of the prohibitions makes it particularly important for the lender and developer to explore the question of whether they, their affiliates, lessees, or prospective purchasers of the project fall within any "party-in-interest," "fiduciary," or "disqualified person" definitions of the Code or ERISA. "Party-in-interest" is defined at 29 U.S.C. § 1002 (14) (1975) (Pub. L. No. 93-406, § 3(14), 88 Stat. 832 (1974)), "fiduciary" is defined at 29 U.S.C. § 1002 (21) (1975) (Pub. L. No. 93-407, § 3(21), 88 Stat. 832 (1974)) and I.R.C. § 4975(e)(3), and "disqualified person" is defined at I.R.C. § 4975(e)(2).

19. *See generally* Stein, *The Unrelated Business Income Tax and Other Tax Considerations*, in REALTY JOINT VENTURES: PENSION FUNDS—INSTITUTIONAL INVESTORS—DEVELOPERS 411 (Practicing Law Institute) (1980). The cited outline is dated October 22, 1980, which was prior to the enactment of Pub. L. No. 96-605, § 1106 (1980) which amended I.R.C. § 514(c) by adding subsection (9) thereto, effective for taxable years beginning after December 31, 1980. Of course, a tax exempt lender may be unwilling to give up any significant tax benefits since that may affect the marketability of its interest in the project at a future date.

20. I.R.C. §§ 1501-1504.

Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

dressed below.

The transaction may not be subject to a usury limit.[21] If it is, the parties should structure the transaction in a manner which will negate a usury problem by either appropriating the funds so that they do not take the form of a loan, or insuring that the loan is not subject to or is within applicable usury limitations.[22] Notably, in most situations, the former solution would be the preferred approach.

A recent analysis of the usury implications of equity participation arrangements suggests that one means to avoid usury restraints is to subject the lender's contribution or loan to risk of loss.[23] While logically it may seem that the usual equity participation arrangement encompasses the concept of sharing both economic profits and losses, thereby negating the problem, the traditional reluctance of lenders to assume substantial risks of loss[24] necessitates consideration of this factor during the negotiating process. For example, when the lender insists on a guaranteed return of its capital contribution, guaranteed or cumulative cash flow distributions or capital withdrawals at set rates, construction guarantees, preferred returns on sale or refinancing, and control of the sale of the project, it may have no substantial risk of loss. Undoubtedly, as the lender's risks decline, the usury question becomes more serious.[25] Thus, the parties should scrutinize such

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21. *See* Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, §§ 501, 511-512, 94 Stat. 132, *as amended by* Pub. L. No. 96-399, § 324, 94 Stat. 1647 (preempting, among other things, any usury limitations with respect to residential real property). It should be noted that the Arkansas Supreme Court recently has addressed the validity of the Depository Institutions Deregulation and Monetary Control Act of 1980. The court, upon rehearing, determined that the act was valid and precluded a finding of usury in a situation that otherwise would clearly have been usurious under the Arkansas Constitution. *McInnis v. Cooper Communities, Inc.*, No. 80-254 (Ark. Sup., Feb. 23, 1981). The court had originally held, in an opinion in the same case issued on December 22, 1980, and amended on December 29, 1980, that the act was not valid and that the transaction was usurious.

22. *Id. See generally* Pedersen & Cox, *Choice Of Law And Usury Limits Under Texas Law And The National Banks Act*, 34 Sw. L.J. 755 (1980).

23. Comment, *Equity Participation In Texas: A Lender's Dream Or A Usurious Nightmare?*, 34 Sw. L.J. 877, 888 (1980).

24. *See generally* Hartman, *Economics Make Strange Bedfellows: The Institutional Joint Venture*, 2 REAL EST. REV. 62 (1972); Roegge, Talbot & Zinman, *Real Estate Equity Financing and the Institutional Lender: Nothing Ventured, Nothing Gained*, 39 FORDHAM L. REV. 579, 586 (1971).

25. Comment, *Equity Participation In Texas: A Lender's Dream Or A Usurious*

St. Mary's Law Journal, Vol. 12 [1980], No. 4, Art. 4

matters in instances where there are or may be applicable usury limitations.

III. Choice of Project Entity

Many factors must be considered in selecting the form of entity or structure to own the project in an equity participation arrangement. Among the more important factors which the form of ownership will affect are: (1) the taxation of the profits of the project, the ability of the parties to offset income and losses arising from the project against the results of other activities in which the parties are engaged separately, and the characterization of the mortgage financing provided by the lender as debt or equity for tax purposes; (2) the extent to which separate activities and assets of the parties are exposed to or insulated from additional liabilities arising out of the operations of the project; (3) the reduction or enhancement of the ability of the parties to exercise control over the project; (4) the effect, if any, which the form of ownership will have on the terms and availability of mortgage financing for the project; (5) the ability to obtain title insurance deemed necessary for the project by the parties; and (6) the means of admitting additional investors into the project at some point in the future and the extent to which such admissions are controlled. Each of these factors is discussed in the context of the basic arrangements for owning the project ordinarily considered in the course of reaching a decision on this issue.

A. *Use of a Corporation*

1. *Tax Considerations.* Two primary tax disadvantages are usually attributed to choosing a corporation to own a real estate project. One disadvantage is that the losses generated during the early years of the project's existence can not be directly "flowed through" to the income tax returns of the developer and lender.[26] The second disadvantage is that the income generated during the

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Nightmare?, 34 Sw. L.J. 877, 897 (1980).

26. Operating losses of a regular business corporation would be used to determine the taxable income of the corporation only, but could be carried forward and applied against income received by the corporation in subsequent years, subject to the applicable limitations. *See* I.R.C. §§ 63, 172.

Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

later years of the project will be subject to double taxation.[27] In most situations, these disadvantages are real and indicate that some other form of owning the project should be considered. In some situations, however, these disadvantages may be more apparent than real, and careful analysis may indicate that the tax and other objectives of the parties can be achieved in a satisfactory manner by using a corporation to own the project.

It should be noted that it is almost never possible to utilize an electing small business corporation to own the project and thereby obtain the benefits of subchapter S of the Code.[28] The principal obstacle is that the developer or lender will ordinarily be an entity which is not eligible to own stock in an electing small business corporation.[29] Another obstacle is that all, or substantially all, of the income of the corporation will usually be comprised of passive investment income, a fact that will terminate any election made by the corporation to be treated as a small business corporation.[30]

Recently promulgated final regulations under section 385 of the Code must be considered if the lender is making a mortgage loan for the project to a corporation in which the lender owns stock.[31] The regulations set forth rules under which purported debt instruments issued by a corporation may be recharacterized as equity in certain circumstances.[32] Such recharacterization would cause amounts presumably paid as tax-deductible interest payments on a mortgage loan to be recast as non-deductible dividends, with principal payments on the loan being recast as distributions subject to

27. Regular corporate income tax ordinarily will be paid at the time the income is earned by the corporation which owns the project. The amount distributed by the corporation as a dividend or liquidating distribution will be taxed again as ordinary income or capital gain at the time such amounts are received by the developer or lender as a result of their stock ownership. *See* I.R.C. §§ 11, 301.

28. *Id.* §§ 1371-1379.

29. *Id.* § 1371(a)(2). Only individuals, estates, and certain trusts may own stock in an electing small business corporation.

30. *Id.* § 1372(e)(5)(C). It is assumed for purposes of this discussion that "significant services" are not rendered for the occupant(s) of the project. *See* Treas. Reg. § 1.1372-4(b)(5)(b)(vi).

31. Treas. Reg. §§ 1.385-1 to -10 (adopted December 29, 1980, by T.D. 7747). The regulations are generally applicable to, among other things, loans made after April 30, 1981. They do not apply to loans made pursuant to a binding written agreement in effect on December 29, 1980, and at all times thereafter. *Id.* § 1.385-1(a)(1) & (2).

32. The circumstances under which such recharacterization may occur are beyond the scope of this article.

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St. Mary's Law Journal, Vol. 12 [1980], No. 4, Art. 4

the provisions of section 301 of the Code.[33] While these rules ordinarily would not apply to a loan made to a corporation in which the developer has a substantial equity interest,[34] great care must be exercised to assure that any such loan would not be recharacterized as equity with the attendant adverse tax consequences.

One situation in which the use of a corporation as the owner of a project may be considered is where the parties are not concerned with obtaining immediate tax benefits by offsetting losses against their income from other activities. This situation may arise because the parties are tax exempt, have a low effective tax rate, or have sufficient losses or loss carry-overs from other activities, making any pass-through of losses on the project unnecessary. The parties may be willing, therefore, to let the corporation retain losses generated by the project during the early years of its existence, and to utilize those losses as carry-overs against income generated by the project during the later years of its existence with a view toward selling either the stock of the corporation or the project in a manner which would enable them to treat the net proceeds of the sale as long-term capital gains.[35] In the meantime, the net cash flow of the project would be distributed at times when the corporation did not have any earnings and profits, so that the distributions would be tax-free to the extent of the shareholders' basis in their stock and treated as long-term capital gains to the extent they exceeded the shareholders' basis in their stock, assuming the shareholders satisfied the other requirements for treatment of such amounts as long-term capital gains.[36] In any event, distributions determined to have been made out of earnings and profits (constituting dividends) would be subject to the 85% dividends received

33. Treas. Reg. § 1.385-4(c).

34. *See id.* § 1.385-6 (relating to proportionality). If the developer owns a substantial equity interest, the instrument evidencing the putative debt held by the lender would not be considered substantially proportionate to the stock ownership.

35. Presumably the stock of the corporation would be a capital asset. *See* I.R.C. § 1221. If the project were sold, the parties would attempt to structure the transaction in a way that would result in capital gain treatment of the proceeds of the sale. The various considerations which should be taken into account in that regard and methods that may be available to achieve capital gain treatment are beyond the scope of this article. *See generally* S. MORRIS, REAL ESTATE TAX PLANNING §§ 5.4-.5 (1977 & Supp. 1979) (presents various matters to be considered in this respect).

36. *See* I.R.C. § 301.

deduction if received by shareholders who were also corporations,[37] thus double taxation of those distributions would be alleviated substantially.

The use of a corporation to own the project might also be considered where one of the parties will own 80% or more of the equity interest in the project and is eligible to file consolidated corporate income tax returns.[38] If the other party is willing to utilize a corporation because of its tax status or other concessions which it receives, the 80% owner can offset the losses generated by the project against its other income by means of filing a consolidated income tax return with the corporation which owns the project.[39] In this regard, the parties should consider the fact that a corporate owner of the project immediately could deduct construction period interest and taxes.[40]

Any tax advantages that may be obtained by using a corporation in either of these situations can be obtained equally as well or better by using another form of ownership for the project. In addition, the factors involved in these two situations do not have wide applicability to most real estate projects. Consequently, lacking other important reasons for selecting a corporation, tax considerations usually weigh heavily against utilizing a corporation to own the project.

2. *Liability Considerations.* One factor which initially appears to strongly favor corporate ownership of a project is the extent to which such a technique insulates other assets and activities of the parties from liabilities associated with the project.[41] This same degree of insulation can be achieved, however, by utilizing a corporate subsidiary to own each party's interest in the project entity.[42] To some extent, at least with respect to one of the parties, a degree

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37. *Id.* § 243.

38. *Id.* §§ 1501-1504.

39. Treas. Reg. § 1.1502-21.

40. I.R.C. § 163, 189. It is noted that the at risk rules do not apply to the holding of real property and, therefore, are not discussed in this article. *See id.* § 465(c)(3)(B). Section rules, however, should be considered in connection with ownership of an interest in subsidiaries. *See* Howard & Rosenburg, *Temp. Regs. bar use of sub to shirt "at risk" limits on consolidated returns,* 53 J. OF TAX. 6 (1980).

41. *See generally* Hamilton, *The Corporate Entity,* 49 TEXAS L. REV. 979 (1971).

42. There may, however, be more of a tendency to "pierce the corporate veil" if the shareholder is itself a corporation. *See* Hamiltion, *The Corporate Entity,* 49 TEXAS L. REV. 979, 989 (1971).

St. Mary's Law Journal, Vol. 12 [1980], No. 4, Art. 4

of insulation can also be achieved by utilizing a limited partnership to own the project.[43] In addition, insurance is usually available to cover most liabilities which are of principal concern to the parties. Consequently, the parties ultimately may not consider this factor particularly significant in selecting the form of ownership for the project.

3. *Control Considerations*. The parties are often concerned about the extent to which the selection of the form of ownership affects their ability to control decisions made with respect to the project. In this regard, using a corporation ordinarily will not be satisfactory to either party.

If the developer and lender each have 50% of the ownership interest in their equity participation arrangement, the possibility of a stalemate exists if their 50% ownership interests are comprised of owning one-half of the stock of a corporation. When either party owns more than a 50% interest, it is very difficult, if not impossible, for the other party to exercise effective control over the routine management of the project or, in some situations, over fundamental decisions affecting the project.

Where a corporation is used to own the project, the members of the board of directors have control over the routine management of the project and the corporation, through their election of the corporate officers to handle day-to-day matters and their decisions on more important policy matters not requiring shareholder approval.[44] Lacking some type of voting agreement, the party owning more than 50% of the stock of the corporation is able to elect all of the directors of the corporation, or, if cumulative voting is in effect, at least a majority of the directors.[45] Although the minority shareholder could require, as a condition of the basic agreement, that the majority shareholder enter into a voting agreement under which their shares would be voted for specified directors, such agreements have certain inherent limitations.[46] First, the term of

43. *See* TEX. REV. CIV. STAT. ANN. art. 6132a, § 8 (Vernon Supp. 1980-1981); REVISED UNIFORM LIMITED PARTNERSHIP ACT § 303; UNIFORM LIMITED PARTNERSHIP ACT § 7.

44. TEX. BUS. CORP. ACT ANN. art. 2.31 (Vernon 1980). For example, at least two-thirds of the shareholders would have to approve any sale, lease, exchange, or other disposition of all or substantially all of the assets of the corporation which is not in the ordinary course of business. *Id.* art. 5.10.

45. *Id.* art. 2.29(D).

46. *Id.* art. 2.30.

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Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

voting agreements is limited to ten years.[47] Second, since such agreements are limited to matters which are properly the subject of shareholder action and cannot control decisions which are within the province or the authority of the directors, it is impossible to assure that decisions made by the specified directors will always be consistent with the limitations the principals seek to impose. Finally, while it is unlikely that the majority shareholder would be willing to agree to naming an evenly balanced group of directors in the voting agreement, if it were willing to do so, the prospect of reaching a stalemate at the board of directors level would remain.

The minority shareholder could ameliorate some of the inherent limitations of a voting agreement by also requiring, as a condition of the basic agreement, that the majority shareholder agree to a super-majority quorum requirement for actions by the board of directors, so that the minority shareholder could keep its directors away from meetings of the board of directors, thereby denying the majority the quorum needed to pursue or continue a course of action which the minority shareholder found objectionable. The two-sided nature of such a provision would, of course, have to be emphasized strongly by counsel to a minority shareholder seeking advice on such matters.

A minority shareholder can usually gain more effective control over fundamental decisions affecting the corporation and the project than it can over routine management decisions. Such control can be obtained by: (1) acquiring sufficient stock to veto actions requiring more than a simple majority vote under corporate law;[48] (2) insisting on a sufficiently higher voting requirement in the articles of incorporation with respect to specified matters so that the percentage of stock which it does obtain results in a veto power; (3) negotiating a voting agreement under which it effectively is given a veto power over decisions requiring shareholder approval; or (4) requiring that the articles of incorporation be written so that certain matters which would ordinarily be within the province of

47. *Id.* art. 2.30.

48. *E.g.*, *id.* art. 4.02 (amending the articles of incorporation); *id.* art. 5.03 (approval of a merger or consolidation); *id.* art. 5.10 (disposition of assets other than in the ordinary course of business); *id.* art. 6.03 (dissolution).

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St. Mary's Law Journal, Vol. 12 [1980], No. 4, Art. 4

the board of directors require shareholder approval.[49]

As suggested, a minority owner's desire to insure participation in the control of the project owned by a corporation may involve cumbersome solutions, with attendant additional legal costs. This problem, in most cases, can be solved more easily by utilizing other forms of ownership.

4. *Effect on Mortgage Financing.* Until recently, usury considerations often made it important to use a corporation, at least nominally, to own real estate projects.[50] Statutes were enacted in Texas in 1977 and 1979 which removed the usury distinction between a corporate borrower and individual or partnership borrowers with respect to most real estate projects.[51] Further, the recent enactment of the federal preemption statute[52] has diminished, if not eliminated, the usury aspects of the choice between a corporation and other arrangements for owning a real estate project.

One instance, in which the use of a corporation may be significant in connection with mortgage financing, relates to the question of what relationship exists when the lender which makes a mortgage loan for a real estate project is also an owner, directly or indirectly, of a substantial interest in the project encumbered by the mortgage. Unlike certain other ownership arrangements, the use of

49. *E.g., id.* art. 2.15(B) (fixing the consideration for shares without par value); *id.* art. 2.23 (amending the bylaws); *id.* art. 509 (authorizing mortgages and sales in the ordinary course of business).

50. The maximum allowable interest rate for corporations under Texas law was 1½% per month, or 18% per annum, while the maximum rate for individuals and partnerships was 10% per annum. TEX. REV. CIV. STAT. ANN. arts. 1302-2.09, 5069-1.02 (Vernon 1971). Accordingly, if the market interest rates were above 10% per annum, it was necessary to form a corporation to borrow the mortgage financing, providing for interest at a rate in excess of 10% per annum. A corporation which was used to hold legal title to the real estate for purposes of obtaining a mortgage loan in excess of the rate applicable to individuals or partnerships often proved a poor choice for federal income tax purposes if the corporation was intended solely as a nominee, with the parties intending that the tax benefits from ownership of the property pass through to the beneficial owners thereof. *See, e.g.,* 1 W. MCKEE, W. NELSON & R. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 3.10 (1977); Baker & Rothman, *Straw corporations: New cases shed light on tax-recognition criteria,* 45 J. OF TAX. 84 (1976). The position of the Internal Revenue Service on this issue is generally that the intended flow-through will not work, as clearly set forth in recent technical advice memoranda issued by the national office. *See* Private Letter Rul. 8105040 (Oct. 31, 1980).

51. TEX. REV. CIV. STAT. ANN. art. 5069-1.07 (Vernon Supp. 1980-1981).

52. See note 21 *supra.* Certain limits still apply, however, with respect to non-residential real estate loans.

Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

a corporation should result in a clear distinction between the role of the lender as a lender and the role of the lender as an owner of an equity interest in the project. The fact that the corporation, and not its shareholders, is the debtor with respect to the mortgage financing precludes the sort of ambiguity as to the relative rights and obligations of the developer, lender, and third-party creditors which may exist with other forms of ownership if the revenues of the project are insufficient to satisfy the debt service on the mortgage financing.[53]

5. *Effect on Title Insurance.* The use of a corporation to own the project may offer limited benefits to the parties with respect to title insurance on the project. The principal concern with respect to title insurance in an equity participation arrangement is that one of the parties will have knowledge concerning a title problem which is not disclosed to the title insurer, thereby relieving the title insurer of liability under the title insurance policy should there be a failure of title because of the known but undisclosed defect.[54] This problem is of particular importance to the lender since the developer is usually the party most familiar with the project site and related potential title problems.

If a corporation is used to own the project, an argument can be made that, although the knowledge of an officer of the developer concerning an undisclosed title defect would be attributed to the developer, such knowledge should not be attributed to the corporation owning the project based solely upon the developer's stock ownership in that corporation, because a shareholder, as such, ordinarily is not considered to be an agent of a corporation.[55] An

53. As noted in succeeding portions of this article, the position of the lender and its mortgage financing may become somewhat unclear if the ownership of the project is held in a co-tenancy, limited partnership, or joint venture. The fact that a properly organized and maintained corporation will be regarded as a distinct legal entity separate and apart from its shareholders should avoid the questions regarding such matters which may arise in connection with other forms of ownership.

54. The Texas State Board of Insurance is authorized to promulgate forms for title insurance in Texas. TEX. INS. CODE ANN. art. 9.07 (Vernon Supp. 1980-1981). Pursuant to that authority, the Board of Insurance has adopted Form T-1, "Owner Policy of Title Insurance" (July 1, 1980), which excludes from coverage any liens or other defects which are "known to the Insured at the date of this policy unless disclosure thereof in writing by the Insured shall have been made to the Company prior to the date of . . . [the] . . . policy. . . ." "Insured" is defined as the named insured and various successors in interest. A similar exclusion is contained in the policy form for a mortgagee's policy. *Id.*

55. *See* Atlas Petroleum Corp. v. Galveston, H. & S. A. Ry. Co., 5 S.W.2d 215 (Tex. Civ.

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argument can also be made that such knowledge should not be imputed to the corporation which owns the project, even if the officer of the developer who possessed the knowledge also becomes an officer of the corporation owning the project, because such knowledge was not acquired as a representative of that corporation.[56] Consequently, it is possible that a lender may obtain greater protection from undisclosed title defects if the project is owned by a corporation rather than another form of ownership arrangement. There is no assurance, however, that a lender could obtain complete protection from such undisclosed title defects which are known to an officer of the developer, and a court may apply equitable principals to deny recovery from the title insurer in such instance.[57]

6. *Effect on Admitting Investors.* It is possible that either party may wish to structure their equity participation arrangement to allow flexibility to admit new investors for purposes of providing capital to cover unanticipated cost overruns, operating deficits, or to recover capital initially invested in the project after it has been completed and initially leased. Because of the inability to "flow through" tax benefits to the beneficial owners of a project owned by a corporation, the parties will not be able to attract investors by means of emphasizing the tax benefits attributable to such investment. In addition, it is unlikely that investors will be readily available whose tax situation is such that they can ignore the tax benefits which are presented by alternative offerings and invest in a particular project solely on the basis of the economics of the project itself.

One benefit which the use of a corporation does provide is that the lender and developer can be somewhat less concerned about the ancillary consequences of admitting new investors than they might be in the context of another ownership arrangement. Since the new investors will not be able to bind the lender and developer to unanticipated liabilities, the admission of new stockholders should give the lender and developer little or no concern as long as

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App.—El Paso 1928, writ ref'd); Itasca Roller Mill & Elevator Co. v. Wooten, 246 S.W. 678 (Tex. Civ. App.—Dallas 1922, no writ). *But see* Searle-Taylor Mach. Co. v. Brown Oil Tools, Inc., 512 S.W.2d 335 (Tex. Civ. App.—Houston [1st Dist.] 1974, writ ref'd n.r.e.).

56. *See* Taylor v. Callaway, 27 S.W. 934 (Tex. Civ. App. 1894, writ dism'd).

57. *See* Searle-Taylor Mach. Co. v. Brown Oil Tools, Inc. 512 S.W.2d 335 (Tex. Civ. App.—Houston [1st Dist.] 1974, writ ref'd n.r.e.).

Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

they maintain sufficient stock ownership to have effective control over the election of directors.[58]

7. *Summary of Considerations.* Although there may be some situations in which the use of a corporation to own the project in an equity participation arrangement may have certain advantages, the use of a corporation generally provides few, if any, advantages and a number of significant disadvantages. In most instances, therefore, the parties will consider other types of ownership arrangements.

B. *Use of a Limited Partnership*

1. *Tax Considerations.* Unlike a corporation, use of a limited partnership would enable the lender and developer to "flow-through" the tax benefits of the ownership of the project during the early years of its existence to offset other income of the parties from separate activities.[59] Any income from operations of the project during the later years of its existence would be "flowed-through" to the partners without incurring double taxation.[60] Because of increasing principal amortization on the mortgage financing and declining depreciation deductions, a potentially adverse result of this latter feature is that taxable income allocated to the partners through the partnership normally begins to exceed the cash flow distributed to the partners in the later years of the project's existence. The parties usually contemplate, however, that the project will be sold when this "cross-over" point is reached. The parties also anticipate that the profit realized on a sale of the project at that time will be taxed at long-term capital gains rates, subject to recapture as ordinary income of the portion of the gain equal to any depreciation which has been claimed in excess of

58. Minority shareholders do have various rights in connection with corporate matters; however, such rights are generally not sufficient to block corporate action if the stock ownership is not more than one-third of the stock entitled to vote on the specific matter. See note 48 *supra*.

59. *See* I.R.C. § 702(a). Although there may be some variation, the textual discussion assumes that the lender is the limited partner and the developer is the general partner. For an overview of the conduit theory of taxation of partnership operations, see 1 W. McKee, W. Nelson & R. Whitmire, Taxation of Partnerships and Partners ¶ 1.01 (1977); S. Morris, Real Estate Tax Planning § 4.1 (1977); 1 A. Willis, Partnership Taxation § 6.01 (1976).

60. *See* I.R.C. § 702(a).

St. Mary's Law Journal, Vol. 12 [1980], No. 4, Art. 4

straight-line depreciation.[61] In general, therefore, the tax considerations of using a limited partnership to own the project are favorable.

There are some troublesome tax areas, however, which must be taken into account. A threshold question which must be resolved favorably before a limited partnership can be used to own the project involves assuring that the partnership will be classified as a partnership for tax purposes and not as an association taxable as a corporation.[62] Obtaining this assurance requires an analysis of the four major corporate characteristics of continuity of life, centralization of management, free transferability of interests, and limited liability in order to determine that the proposed limited partnership does not possess more than two of these corporate characteristics.[63]

a. *Continuity of Life.* Ordinarily, a limited partnership formed under a statute substantially conforming to the Uniform Limited Partnership Act will not possess the corporate characteristic of continuity of life, because the dissolution of the general partner will result in the dissolution of the partnership.[64] The fact that the limited partners may agree to reform and continue the partnership by appointing a new general partner will not adversely affect this conclusion.[65]

b. *Centralization of Management.* A limited partnership does not possess the corporate characteristic of centralization of management unless the limited partners own substantially all of the beneficial interest in the partnership.[66] Consequently, when the de-

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61. *See id.* §§ 702(a), 1250.

62. *Compare* I.R.C. § 7701(a)(2) (defines partnership as "a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on . . .," specifically excluding a corporation, trust, or estate) *with id.* § 7701(a)(3) (defines corporation as including "associations, joint-stock companies, and insurance companies"). *See generally* S. MORRIS, REAL ESTATE TAX PLANNING § 4.5 (1977 & Supp. 1979) (discusses general considerations applicable to this area).

63. *See* Treas. Reg. § 301.7701-2.

64. *See* TEX. REV. CIV. STAT. ANN. art. 6132a, § 21 (Vernon 1970); REVISED UNIFORM LIMITED PARTNERSHIP ACT § 801; UNIFORM LIMITED PARTNERSHIP ACT § 20. Texas incorporated the Uniform Limited Partnership Act in article 6132a. *See* TEX. REV. CIV. STAT. ANN. art. 6132a (Vernon 1970 & Supp. 1980-1981).

65. *See* Treas. Reg. § 301.7701-2(b).

66. *See id.* § 301.7701-2(c). It should be noted, however, that the Service recently has proposed regulations which would make the centralization of management issue a factual question if all or part of the limited partners are able to remove a general partner. The

veloper owns a significant interest in the partnership, and the developer and lender are independent, this characteristic is not ordinarily present. If, however, the developer's interest is relatively small or is subordinated to cash flow and liquidation preferences in favor of the lender to such an extent that the developer may actually not receive any distributions from the partnership, the Internal Revenue Service (Service) may take the position that substantially all of the beneficial interest in the partnership is held by the lender and that the corporate characteristic of centralization of management does exist.[67] A similar position may be taken if the lender owns a significant equity interest in the developer. In this regard, it should be noted that the Service will not issue a favorable advance ruling with respect to the partnership status of a limited partnership with a sole corporate general partner if the limited partners own more than 20% of the stock of the corporate general partner.[68]

Although the problem of centralization of management should not arise initially, where the developer and lender are completely independent, it should be borne in mind when negotiating the agreement between the parties and in the future conduct of the arrangement.[69] The problem of having the partnership treated as an association taxable as a corporation may be avoided if the problem is recognized at or prior to the time it arises. The danger, however, is that the problem would not be timely perceived. The opportunity for avoiding the adverse tax consequences of the changed classification of the partnership to a corporation could be lost for

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proposed regulations state that: "A substantially restricted right of the limited partners to remove the general partner *(e.g.,* in the event of the general partner's gross negligence, self-dealing, or embezzelment) will not itself cause the partnership to possess centralized management." Prop. Treas. Reg. § 301.7701-2(c)(4), 45 Fed. Reg. 70909 (1980).

67. *See id.* § 301.7701-2(c).

68. *See* Rev. Proc. 72-13, 1972-1 C.B. 735. Although the Service has taken this position in the area of advance rulings, where it has considerable discretion, the standard is not expressly applicable to audits. It may well be applied by an agent, however, at least tacitly, in an examination of the partnership's tax return.

69. For example, a lender which requires a pledge of the developer's stock to secure the performance of the developer's obligations to the lender or guarantees of those obligations by the developer's shareholders may find itself in the awkward position of endangering the classification of the partnership for tax purposes if it should foreclose such pledge and acquire ownership of the stock. *See id.* A similar problem could arise if the lender obtains a pledge of the developer's partnership interest and that interest is acquired by a subsidiary of the lender upon foreclosure.

several years, or even permanently, and additional taxes and interest needlessly incurred.[70]

c. *Free Transferability of Interests.* The concern of both the developer and lender to avoid having to deal with parties other than the ones with whom they reach their initial agreement often results in such controls over transfers of interest in the partnership that there will be no danger of the partnership's having the corporate characteristic of free transferability of interests.[71] In some cases, however, one of the parties, usually the lender, will have sufficient bargaining strength to be able to negotiate fairly liberal terms with regard to transferability of interests in the partnership. In addition, lenders may be subject to regulatory requirements regarding liquidity of such investments which prevent them from agreeing to stringent restrictions on transfers of interests in the partnership.[72] As a result, a lender may not be able or willing to agree that transfers of its limited partnership interest will require approval of the developer general partner of the type which would ordinarily be utilized to avoid the corporate characteristic of free transferability of interests.

The classification regulations draw a distinction between the ability simply to transfer an interest in a limited partnership to an assignee, which can be done without approval of the other partners, and the ability to designate an assignee as a substitute limited partner, which requires the approval of the other partners.[73] This distinction is often overlooked, and may not be acceptable to a lender which desires or is required to be in a position of tranferring its entire limited partnership interest to a transferee which will be entitled to be admitted as a substitute limited partner with-

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70. For example, gain might be realized at the time of the change in classification, elections on matters such as accelerated depreciation could be lost, taxes could be incurred at the partnership/association level, distributions to the lender could be treated as dividends, and other related problems could occur. *See generally* 1 W. McKee, W. Nelson & R. Whitmire, Federal Taxation of Partnerships and Partners ¶ 3.01[3] (1977).

71. *See* Treas. Reg. § 301.7701-2(e).

72. For example, the authors have been advised that the Federal Home Loan Bank Board imposes such a requirement in the course of approving joint venture investments by federal savings and loan associations. In addition, lenders subject to the "prudent man" rule of ERISA may be under an obligation to preserve the liquidity of such investments, although the requirements of such rule in this area are not yet well-established. *See* Kanner, *Financing Ideas—Pension Fund Investment in Real Estate,* 8 Real Est. L.J. 343 (1980).

73. *See* Treas. Reg. § 301.7701-2(e)(1).

out the approval of the developer general partner.

d. *Limited Liability*. Limited liability may be the most difficult characteristic to overcome in certain situations. Under the classification regulations, this characteristic does not exist unless the general partner has no significant assets and is acting merely as the agent of the limited partners.[74] The fact that the liabilities of the partnership may be far greater than the assets of the developer general partner does not require an adverse result under the classification regulations so long as the developer general partner has significant asets which may be reached by creditors.[75] In most cases, developers chosen by lenders for equity participation arrangements have significant assets. Similarly, developers typically insist on having an ownership interest and control rights sufficient to negate a conclusion that the developer general partner is acting as the agent of the lender limited partner. It is possible, of course, for developers to suffer financial reverses. If that should occur, where the developer has a relatively small interest in the partnership and the lender has negotiated severe restrictions with respect to the actions which the developer can take without the lender's approval, it is possible the nature of the partnership would have changed sufficiently that the corporate characteristic of limited liability would exist. If the partnership then possessed at least two other of the major corporate characteristics, it would be subject to reclassification as an association taxable as a corporation with the attendant adverse tax consequences.[76]

An equally troublesome problem regarding the concept of limited liability is the position of the Service that it will not issue a favorable advance ruling with respect to the partnership status of a limited partnership which has a sole corporate general partner, unless the general partner has a net worth equal to an amount which is at least 15% of the limited partners' contributions up to $2,500,000 or at least 10% of the limited partners' contributions if the limited partners' contributions exceed $2,500,000.[77] Although this requirement does not appear on its face to be unduly onerous, several aspects of the Service's position in this regard are particu-

74. *See id.* § 301.7701-2(d)(1).
75. *See id.* § 301.7701-2(d)(1).
76. *See id.* § 301.7701-2(a)(3).
77. *See* Rev. Proc. 72-13, 1972-1 C.B. 735.

St. Mary's Law Journal, Vol. 12 [1980], No. 4, Art. 4

larly troublesome. In calculating the net worth of the developer, its assets are valued at their fair market value, which seems equitable. Assets comprised of the developer's interest in and accounts receivable from the limited partnership in question, as well as its interests in and accounts receivable from similar limited partnerships, however, are excluded from the computation of the general partner's net worth for purposes of satisfying this requirement.[78] Consequently, a developer which has been active in limited partnership syndications and limited partnership equity participation arrangements and has few assets other than its interests in such partnerships may have difficulty meeting this net worth requirement. Although this is a condition for issuing advance rulings and not an explicit audit guideline, the parties would be more secure that the partnership lacks the corporate characteristic of limited liability if this net worth requirement is satisfied by the developer at the outset. Care must be taken to assure that the developer maintains such net worth throughout the existence of the partnership, in order to avoid an inadvertent reclassification of the partnership as an association taxable as a corporation.[79]

Assuming that the parties are satisfied that the partnership initially will be classified as a partnership for tax purposes, and have taken appropriate steps to minimize the risk of an inadvertent reclassification of the partnership as an association taxable as a corporation in the future, they will still need to consider other tax aspects of a limited partnership, including the question of whether mortgage financing provided by the lender will be treated as debt or equity for tax purposes. As most of these issues relate to any type of partnership which is used to own the project, and may not relate directly to the question of choosing a limited partnership vehicle to own the project, they are discussed below.

2. *Liability Considerations.* A major inducement for a lender to utilize a limited partnership as the ownership vehicle for the project is the extent to which a lender may minimize its liability as a limited partner. Although it is generally true that a lender may be insulated from liability as a limited partner in a manner which is unavailable in the context of other ownership arrangements,

78. *Id.*

79. *See generally* 1 W. McKee, W. Nelson & R. Whitmire, Federal Taxation of Partnerships and Partners ¶ 3.07 (1977).

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there are some qualifications regarding this general rule which must be kept in mind.

The Texas Uniform Limited Partnership Act (TULPA)[80] provides that a limited partner is not liable for the obligations of the limited partnership beyond the amount of its agreed capital contributions, unless the limited partner receives a distribution of capital from the limited partnership or takes part in the control of the business of the limited partnership.[81] Each of these exceptions to the general rule of limited liability should be considered by a lender in choosing and negotiating the structure of a limited partnership arrangement to own the project.

Under the TULPA, a limited partner which receives a distribution of capital from the limited partnership is liable to return the amount distributed, plus interest, if necessary to satisfy creditors whose claims arose prior to such distribution.[82] It appears that most net cash flow distributions made during the early years of the project's existence may be deemed to have been made from capital, because the partnership would not have realized income for either tax or accounting purposes from which such distributions could be claimed to have been made.[83] This treatment is usually inconsistent with the view of the parties, in that they distinguish between distributions of net cash flow, viewed as distributions of operating revenues, regardless of whether they are treated as such for either accounting or tax purposes, and distributions of the proceeds of capital transactions such as sale or refinancing which are considered the real distributions of capital. Nevertheless, if cash flow distributions are treated as distributions of capital for purposes of the TULPA, a lender which had made all of the capital contributions which it had agreed to make under the limited partnership agreement may be liable for what it considers additional capital contributions. Although this result might be avoided by filing an

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80. TEX. REV. CIV. STAT. ANN. art. 6132a (Vernon 1970 & Supp. 1980-1981).

81. *See id.* §§ 3, 18 (Vernon Supp. 1980-1981). *See also* REVISED UNIFORM LIMITED PARTNERSHIP ACT § 403; UNIFORM LIMITED PARTNERSHIP ACT § 9.

82. *See* TEX. REV. CIV. STAT. ANN. art. 6132a, § 18(B)(2)(d) (Vernon 1970). *See also* REVISED UNIFORM LIMITED PARTNERSHIP ACT § 608(a); UNIFORM LIMITED PARTNERSHIP ACT § 17(4).

83. The tax and accounting losses are often generated by non-cash items such as depreciation. Thus, there may be positive cash flow distributions accompanied by tax or accounting losses.

St. Mary's Law Journal, Vol. 12 [1980], No. 4, Art. 4

amended limited partnership certificate to reduce the limited partner's capital contribution obligation each time a distribution of net cash flow or the proceeds of a capital transaction is made, such a technique appears vulnerable because the claims in question would have arisen before the distributions and the amendment.[84]

There has been a great deal of confusion for many years as to the extent to which limited partners may control the actions of general partners without being found to have participated in the control of the limited partnership within the meaning of the TULPA. In 1975, the Texas Supreme Court held that mere participation in the control of the limited partnership's business is sufficient by itself to render limited partners liable to creditors as general partners, and that the creditors need not show that they relied on the authority of the putative limited partner to act as a general partner.[85] This holding was criticized as being inconsistent with the purposes of the TULPA and it was legislatively overruled in 1979 by amending section 8 of the TUPLA to require that the person transacting business with the partnership reasonably believe that the limited partner is a general partner.[86] Even in light of the amendment, however, lenders need to be concerned about the extent of control which they can clearly exercise under the TULPA as limited partners without being open to a charge by a creditor that certain actions constituted taking part in the control of the limited partnership's business and that the creditor reasonably believed that the the lender acted as a general partner.

The TULPA was amended in 1979 to provide that certain actions on the part of limited partners do not constitute taking part in the control of the business of the partnership.[87] There are, however, certain areas of concern in this regard. Among the more important omissions from the list of permitted actions by limited partners is the right to remove the general partner, either with or

84. The technique described in the text also may be objectionable from the developer general partner's view. If the technique worked as against third-parties, it also should work as against the developer general partner, thereby taking away some assets that may otherwise have been available to satisfy the third party before the third party is entitled to seek satisfaction from the developer general partner's separate assets.

85. Delaney v. Fidelity Lease Ltd., 526 S.W.2d 543 (Tex. 1975).

86. TEX. REV. CIV. STAT. ANN. art. 6132a, § 8(a), 8, comment (Vernon Supp. 1980-1981). The comment states that the creditor would normally have to show that the limited partner has been involved in the day-to-day management of the partnership. *Id.* § 8, comment.

87. *See* TEX. REV. CIV. STAT. ANN. art. 6132a, § 8(b) (Vernon Supp. 1980-1981).

https://commons.stmarytx.edu/thestmaryslawjournal/vol12/iss4/4

Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

without cause. Although an argument can be made that such right is so fundamental as to not require elaboration in the TULPA,[88] it is possible that a court could conclude that the exercise, or even the existence, of such a right on the part of the limited partners constitutes taking part in the control of the business of the partnership. The danger of this conclusion appears greatest where the right to remove the general partner is either at the discretion of the limited partners or is based on some sort of performance standards and such right is not limited to situations where the general partner is guilty of fraud or malfeasance in the performance of its duties as general partner.

An issue which is of specific concern to lenders in evaluating the use of a limited partnership to own the project is the extent to which the exercise, or existence, of rights to approve specific actions regarding the project will constitute taking part in the control of the business of the limited partnership. Included among these actions are requirements for lender approval of matters such as construction contracts and subcontracts, operating budgets, rental rates, lease terms, property management contracts, insurance coverages and issuers, and maintenance and service contracts. It appears that most activities such as these would constitute such a regular part of the business of the limited partnership that the general partner ordinarily would be authorized to make determinations on these issues subject only to rather broad restrictions, such as limitations with respect to contracts and transactions with affiliates. In the event that the lender insists on participating in decisions of this nature, it would appear to do so at the peril of being found to have participated excessively in the control of the business of the limited partnership.

For the foregoing reasons, a lender may determine that the potential for limited liability within the context of a limited partnership is either uncertain or would require accepting too many restrictions on its ability to participate in decisions regarding the project considered to be vital from a business standpoint. The

88. *But cf.* TEX. REV. CIV. STAT. ANN. art. 6132a, § 8, comment (Vernon Supp. 1980-1981) (wherein it is stated that the inclusion of the right of the limited partners to remove the general partner may create so much "continuity of existence" as to deny partnership treatment for tax purposes). The comment will be proven correct, in some respects, if Prop. Treas. Reg. § 301.7701-2(c)(4) is adopted, although the proposed regulation deals with centralization of management rather than continuity of life. See note 66 *supra*.

St. Mary's Law Journal, Vol. 12 [1980], No. 4, Art. 4

lender may conclude, therefore, that it would prefer to incur the straightforward liabilities to which it would be exposed as a member of a general partnership[89] in lieu of attempting to limit its liability by trying to force itself into a mold inconsistent with what it considers to be its legitimate business needs.

3. *Control Considerations.* The degree to which a limited partnership gives the parties flexibility to control various actions with regard to the project is related directly to the liability aspects of a limited partnership. Subject to the possibility that the lender limited partner might be exposed to liability as a general partner if it participates excessively in the control of the limited partnership's business,[90] it is generally possible for the parties to reach an appropriate agreement with respect to the degree to which various decisions can be made by the developer general partner without approval of the lender limited partner.

A question does exist under the TULPA as to the extent to which the developer and lender can reach an agreement in an initial limited partnership agreement regarding the terms and conditions under which the project can be sold or refinanced by the developer without the further approval of the lender limited partner. While the TULPA allows the project to be sold or refinanced at any time on terms and conditions approved by a majority of the limited partners, it is not clear whether this approval must be given at the time an actual transaction is being considered or can be given in advance.[91] A total advance and non-specific delegation of authority on this matter by the lender limited partner to the developer general partner would be of questionable validity. In some instances, however, the lender limited partner may agree in advance on specific terms under which the developer general partner would be authorized without further approval of the lender to sell or refinance the project. Since the TULPA does not expressly sanction such advance agreements, they may be subject to challenge. If the lender limited partner subsequently did challenge the validity of such an agreement, however, it presumably would be

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89. *See* TEX. REV. CIV. STAT. ANN. art. 6132b, § 15 (Vernon 1970). *See also* UNIFORM PARTNERSHIP ACT § 15.

90. *See* TEX. REV. CIV. STAT. ANN. art. 6132a, § 8 (Vernon Supp. 1980-1981). *See also* REVISED UNIFORM LIMITED PARTNERSHIP ACT § 403; UNIFORM LIMITED PARTNERSHIP ACT § 9.

91. *See* TEX. REV. CIV. STAT. ANN. art. 6132a, § 8(b)(5)(C) (Vernon Supp. 1980-1981).

Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

liable for damages for its breach.

4. *Effect on Mortgage Financing.* Under section 14 of the TULPA, there is considerable doubt as to the validity of a mortgage granted by a limited partnership to a lender which is also a limited partner of the mortgagor limited partnership.[92] Although it may be argued that section 14 of the TULPA was not intended to invalidate the granting of a mortgage to a lender which was a limited partner unless the partnership was insolvent at the time the mortgage was granted, such conclusion is not clearly supported. There are no Texas cases which state that section 14 of the TULPA does not mean what it purports to say, which is that no limited partner may receive partnership property as collateral security for a loan to or claim against the partnership. Cases in other jurisdictions and most commentators, however, have concluded that provisions corresponding to section 14 of the TULPA do not invalidate a mortgage granted to a lender limited partner as long as the limited partnership is solvent at the time the mortgage is created.[93]

Assuming that section 14 of the TULPA does not invalidate the creation of a mortgage by a solvent limited partnership in favor of the lender limited partner, this provision casts doubt on the validity of the limited partner's continuing to hold the mortgage once the limited partnership subsequently becomes insolvent.[94] Likewise, doubt is raised regarding the validity of payments made by the limited partnership on the debt secured by the mortgage at a time when the partnership has become insolvent.

In addition to the question of the validity of the mortgage, there is some ambiguity in the provisions of the TULPA regarding the relative priority of claims of the lender limited partner and unsecured creditors. Section 14 of the TULPA says that a limited

92. *See id.* § 14(a)(1) (Vernon 1970). *See also* REVISED UNIFORM LIMITED PARTNERSHIP ACT § 303; UNIFORM LIMITED PARTNERSHIP ACT § 13(1)(a).

93. *See* Hughes v. Dash, 309 F.2d 1, 3 (5th Cir. 1962) (applying Florida law); Grainger v. Antoyan, 313 P.2d 848 (Cal. 1957); A.T.E. Fin. Serv., Inc. v. Corson, 268 A.2d 73, 74 (N.J.Ch. 1970); A. BROMBERG, CRANE AND BROMBERG ON PARTNERSHIPS § 93, at 550 (1968); 19 R. HAMILTON, BUSINESS ORGANIZATIONS § 19 (Texas Practice 1973); Krotovil & Werner, *Fixing Up The Old Jalopy—The Modern Limited Partnership Under The ULPA,* 50 ST. JOHN'S L. REV. 51, 62 (1975); Roegge, Talbot & Zinman, *Real Estate Equity Investments And The Institutional Lender: Nothing Ventured, Nothing Gained,* 39 FORDHAM L. REV. 579, 603 (1971).

94. *See* TEX. REV. CIV. STAT. ANN. art. 6132a, § 14 (Vernon 1970).

St. Mary's Law Journal, Vol. 12 [1980], No. 4, Art. 4

partner is on a parity with general creditors of the limited partnership with respect to claims which the limited partner has against the limited partnership.[95] Section 24 of the TULPA implies, however, that secured claims of a lender limited partner are to be accorded their normal priority over the unsecured claims of general creditors.[96] This apparent ambiguity can be resolved in two possible ways. First, if section 14 is interpreted literally, a limited partner could never be a secured party, so the question of priority of its apparently secured claims would not arise. Second, section 14, read in conjunction with section 24, could be interpreted to mean that it is only unsecured claims of limited partners which are on a parity with general creditors, implicitly sanctioning the granting of security and attendant priority, as long as the limited partnership is solvent when the security is granted.[97]

It should be noted that, if the lender limited partner's mortgage is invalidated because of the provisions of section 14, it should only affect the lender's priority with respect to claims against the partnership. The invalidity of the mortgage should not extend the liability of the lender limited partner for the debts of the partnership beyond that for which it would otherwise be liable.[98]

5. *Effect on Title Insurance.* The possibility of encountering title defects regarding the project with respect to which the title insurer may deny liability because of the undisclosed knowledge of such defects by the developer appears to be most acute in the context of using a limited partnership to own the project. Knowledge of an officer of the developer is attributed to the developer, and, consequently, may be attributed to the limited partnership when the developer is the general partner.[99]

From a developer's perspective, this potential title insurance

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95. *See id.* § 14(a).

96. *See id.* § 24(a)(1).

97. *See generally* Hecker, *The Revised ULPA: Provisions Affecting The Relationship Of The Firm And Its Members To Third Parties*, 27 U. KAN. L. REV. 1, 8-11 (1979).

98. *See* Roegge, Talbot & Zinman, *Real Estate Investments And The Institutional Lender: Nothing Ventured, Nothing Gained*, 39 FORDHAM L. REV. 579, 607 (1971). *See also* TEX. REV. CIV. STAT. ANN. art. 6132a, §§ 8, 18 (Vernon 1970 & Supp. 1980-1981).

99. *See* City of Fort Worth v. Pippen, 439 S.W.2d 660, 665 (Tex. 1969) (knowledge of corporate officer attributed to corporation). *See also* TEX. REV. CIV. STAT. ANN. art. 6132a, § 10(a) & art. 6132b, § 12 (Vernon 1970) (knowledge of a partner acting for the partnership which was acquired prior to becoming a partner will be attributed to the partnership when such knowledge was present in the mind of the acting partner).

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Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

problem is minimal in the context of a limited partnership. Since a limited partner ordinarily is not considered to be an agent of the limited partnership, the undisclosed knowledge which officers and directors of the lender may have with respect to title defects affecting the land on which the project is constructed should not be attributed to the limited partnership.[100]

6. *Effect on Admitting Investors.* A limited partnership is a suitable vehicle for the parties to use in order to preserve their flexibility to admit additional investors in the future.[101] Investors admitted as limited partners do not have the same power to bind the partnership or the other partners to unanticipated obligations as they would in a general partnership. Although the developer and lender may have some concern about the necessity of dealing with new limited partners on issues requiring approval by the limited partners,[102] this factor is usually of less importance than the ability of the new partners to bind the partnership or the other partners to unanticipated obligations.[103]

Even if the parties are reluctant to deal with new limited partners, it may be possible, in some situations, to ameliorate this apprehension. For example, where the developer general partner and the lender limited partner each own a 50% interest in the partnership, the lender may be willing to allow the developer to transfer a substantial portion of its interest to new limited partners since the lender controls a majority of the limited partnership interest for

100. *See* TEX. REV. CIV. STAT. ANN. art. 6132a, § 8(b)(3) (Vernon Supp. 1980-1981). As previously noted, it would be unusual, in any event, for the lender to have knowledge of any title defects since, in the normal transaction, the lender is not as involved in the procurement of the property as the developer.

101. *See id.* §§ 9, 10(a)(6) (Vernon 1970). A limited partner can assign its interest in the limited partnership in order to transfer its share of profits and other compensation. Unless approved by all the members, such assignment does not give the assignee all the rights of a limited partner. *See id.* art. 6132a, § 20 (Vernon 1970); REVISED UNIFORM LIMITED PARTNERSHIP ACT §§ 702, 704; UNIFORM LIMITED PARTNERSHIP ACT § 19. *See also* TEX. REV. CIV. STAT. ANN. art. 6132a, §§ 8, 10-11 (Vernon 1970 & Supp. 1980-1981) (regarding general rights of limited partners that may cause the parties some concern).

102. *See* TEX. REV. CIV. STAT. ANN. art. 6132a, § 8 (b)(5) (Vernon Supp. 1980-1981). In addition, limited partners have the same rights as a general partner to: (1) inspect the partnership books; (2) be informed of occurrences significantly relating to the partnership's business; (3) insist upon dissolution and winding up by court decree; and (4) receive income, return of contribution, and other compensation from the partnership. *See id.* § 11 (Vernon 1970).

103. This would be the case if the entity were a general partnership. *See id.* art. 6132b, § 9 (Vernon 1970).

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St. Mary's Law Journal, Vol. 12 [1980], No. 4, Art. 4

purposes of being able to approve or veto matters requiring approval of the limited partners. If the developer is allowed to transfer part of its interest to new limited partners, it may give the lender the right to do the same. The theory underlying this decision is that the developer may be able to persuade new limited partners holding interests assigned by both the lender and developer, thus constituting a majority in interest of the limited partners, to approve actions proposed by the general partner which the lender itself has refused to approve.[104]

7. *Summary of Considerations*. The use of a limited partnership to own the project in an equity participation arrangement provides certain tax advantages that the use of a corporation does not provide. Such advantages, however, are subject to considerable risks, and can be achieved with other forms of ownership. In addition, the use of a limited partnership raises serious questions which the lender must consider regarding limited liability and validity of mortgage financing. If the lender does not wish to participate extensively in the management of the project and is going to provide financing in the form of equity contributions or loans from third party lenders, the use of a limited partnership may be satisfactory to the lender. In most cases, however, the lender will want to consider the use of some other form of ownership arrangement in order to avoid the restrictions on its participation in the management of the project and to attempt to avoid the potential problems of section 14 of the TULPA with respect to mortgage financing which the lender may provide. The developer, on the other hand, may wish to use a limited partnership in order to enhance its control over the project and to minimize the possibility that mortgage financing provided by the lender will be classified as equity capital, as discussed further below.

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104. Approval necessary for an assignee to acquire the status of a substitute limited partner can be obtained by setting out in the limited partnership certificate that the assignor has the right to constitute his assignee as a substitute limited partner. *See id.* art. 6132a, § 20 (Vernon 1970). As a substitute limited partner, the new limited partner may be required to approve of, consent to, or ratify certain actions desired by the general partner. The extent to which less than all of the limited partners could act in this regard presumably would be set forth in the certificate, unless it is an act set forth in section 10, which would require, in some instances, unanimity. *Id.* art. 6132a, §§ 8, 10 (Vernon 1970).

Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

C. *Use of a Co-Tenancy*

1. *Tax Considerations.* A co-tenancy in a typical rental apartment project or office complex is likely to be treated as a general partnership for tax purposes.[105] Accordingly, a great deal of the discussion in this article regarding the tax consequences of general partnerships and joint ventures is equally applicable to a co-tenancy. The danger of using a co-tenancy is that its status as a partnership for tax purposes will not be recognized by the parties. As a consequence, the parties may incur penalties for failing to file partnership tax returns and may neglect certain elections for tax purposes required to be made by the partnership rather than by its individual partners.[106]

2. *Liability Considerations.* A co-tenancy may also be treated as a general partnership for state law purposes.[107] Therefore, much of the discussion in this article concerning the liability consequences of general partnerships and joint ventures may be equally applicable to a co-tenancy.[108] It is possible for a court to conclude that the parties' choice of a co-tenancy to own the project puts third parties dealing with the co-tenants and the project on notice that the joinder of both parties is required and that neither party has the power, acting alone, to bind the other party. Nevertheless, parties attempting to avoid the mutual agency relationship of a general partnership by use of a co-tenancy would be well advised to record in the local deed records the deeds for their undivided interests in the property and a reference to their co-tenancy arrangement which disclaims the existence of a partnership. An assumed name certificate should also be filed for the project clearly

105. *See* I.R.C. §§ 761(a), 7701(a)(2); Treas. Regs. § 1.761-1(a). *See also* Estate of Levine v. Commissioner, 72 T.C. 780 (1979), *aff'd on other grounds*, 634 F.2d 12 (2d Cir. 1980). Although not enumerated within the list of entities designated as a partnership, a co-tenancy would readily fit within the Code's broad definition of a partnership. *See id.*; Treas. Reg. § 301.7701-3. It appears that the co-tenancy envisioned here would not be able to "elect out" of partnership status for tax purposes, at least after it had begun rental of the project, since it would be engaged in a trade or business. *See* I.R.C. § 761(a)(1). *See also* 1 A. Willis, Partnership Taxation § 1.05 (1976 & Supp. 1980).

106. *See* I.R.C. § 6698 (penalty for failure to file return). *See also* 1 W. McKee, W. Nelson & R. Whitmire, Federal Taxation of Partnerships and Partners ¶ 3.01 (1977).

107. The existence of a partnership presumably would be determined under the statutory partnership provisions. *See* Tex. Rev. Civ. Stat. Ann. art. 6132b, § 6 & 7, comments (Vernon 1970).

108. See text accompanying notes 123-26 *infra*.

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indicating that the property is owned by the parties as co-tenants and not as partners.[109] Although these steps may not provide protection against trade creditors lacking actual or constructive notice of the co-tenancy arrangement, it should provide some protection against parties dealing with the project on matters of such magnitude as to impose a burden of inquiry regarding the title to the property.[110]

3. *Control Considerations.* The use of a co-tenancy for the project may solve certain questions of control while creating others. If the title to the property is held by the parties as tenants in common, it will be difficult for either party to take any action with third parties affecting the title to the entire project without the joinder of the other party. On the other hand, if the lender and developer have agreed that certain actions can be taken by one of them without the joinder of the other, it may be possible for the party whose joinder is not required to undermine the agreement when a third party requires the non-joining party to join in the action and it refuses to do so.

A more serious problem which the use of a co-tenancy may create involves the transfer of an interest in the co-tenancy. To avoid this problem, some action must be taken to record any restrictions on transfer or rights of first refusal which have been agreed upon by the co-tenants. Failure to do so may enable either party to convey all or a portion of its undivided interest in the project without the approval or joinder of the other party.[111] When a transferee takes title from one of the parties without notice of any such restrictions or rights, the other party may be forced, without its consent, to deal with one or more additional co-tenants.

4. *Effect on Mortgage Financing.* When the parties structure the ownership arrangement for the project as a co-tenancy and the lender provides the mortgage financing, there may be some question concerning the consideration for the liens securing the financing as to the undivided ownership interest of the lender in the project.[112] When foreclosure of the mortgage is necessary and the

109. *See* TEX. BUS. & COM. CODE ANN. § 36.10(a)(4) (Vernon Supp. 1980-1981). The assumed name certificate should set forth clearly the manner in which the parties hold the project.

110. *See generally* 15 TEX. JUR. 2d *Co-tenancy* §§ 31-32 (1960 & Supp. 1980).

111. *See generally id.* § 13.

112. Since the lender cannot be indebted to itself, it is not clear what consideration

project is purchased by the lender, it appears that the potential problems arising from a possible failure of consideration would not be encountered. The lender obtains title to the entire project and any future conveyance by the lender conveys full title. When the project is purchased by a third party, however, there is a question as to the extent of title obtained by the third party as a result of the trustee's conveyance which evidenced the foreclosure purchase. If the original grant of the mortgage was ineffective as to the lender's undivided interest, it appears that the trustee could transfer only the developer's undivided interest.[113] Consequently, there is a serious question as to the trustee's authority, if any, to conduct a sale of the lender's undivided interest. An argument may be made that the trustee was acting in the dual capacity as trustee under deed of trust with respect to the developer's undivided interest and as agent with power of sale under an implied agency with respect to the lender's undivided interest. The absence of clear written authority for the trustee to act as the agent of the lender, however, would be troublesome to a third-party purchaser seeking to establish title to the entire project and not just to the developer's interest.[114] It seems unlikely, though, that a court would deny the purchaser relief where it had paid a purchase price at foreclosure based on acquiring the entire project and the lender received the benefit of all or part of the amount paid by means of application to its mortgage debt or with respect to its undivided interest in the equity of the project.[115]

These potential problems can be avoided if the lender and developer recognize them at the outset. One solution is for the lender to

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there is for the mortgage liens to the extent they encumber an undivided interest in the project which is owned by the lender at the time the liens are created. *Cf.* Home State Bank v. Cavett, 518 S.W.2d 584, 587-88 (Tex. Civ. App.—Austin 1975, no writ) (deed of trust invalid when grantor received no consideration).

113. Although a trustee under a deed of trust can convey title as a result of a foreclosure sale even if part of the debt is void, see State Mortgage Corp. v. Ludwig, 121 Tex. 268, 279, 48 S.W.2d 950, 955 (Tex. 1932), the trustee cannot convey title exceeding that originally acquired under the deed of trust. *See* Groesbeeck v. Crow, 85 Tex. 200, 205, 20 S.W. 49, 51 (1892); Rosborough v. Picton, 34 S.W. 791, 793, *motion for reh. overruled,* 43 S.W. 1033 (Tex. Civ. App. 1896, no writ).

114. There presumably would be no question as to the validity of the mortgage with respect to the developer's undivided ownership interest as there would have been adequate consideration for the creation of the mortgage on the developer's interest.

115. *See* Jeffrey v. Bond, 509 S.W.2d 563, 565 (Tex. 1974); Harris v. Masterson, 91 Tex. 171, 173, 41 S.W. 482, 483 (1897).

St. Mary's Law Journal, Vol. 12 [1980], No. 4, Art. 4

use a subsidiary to hold the lender's undivided interest in the co-tenancy. An alternative remedy is for the lender to provide mortgage financing structured simply as a loan to the developer of the portion of the initially anticipated loan amount proportionate to the developer's undivided ownership percentage, secured only by the developer's undivided interest in the project. This technique may present regulatory problems to lenders who are authorized to make a loan for the entire amount required, but are not authorized to make an equity investment in an amount equal to its undivided ownership percentage of the initially anticipated loan amount.[116] A developer may also have some reservations about this technique, because selling only its undivided interest in the project may adversely affect the price received at the foreclosure sale. Consequently, a developer may refuse to agree to this technique unless the lender grants the trustee under the deed of trust a separate irrevocable agency power to sell the lender's undivided interest in the project simultaneously with the foreclosure sale of the developer's interest. A lender may not agree to such an arrangement once the agency relationship has been clarified and refined in this manner.

A court may conclude that the relationship between the lender and developer created a separate partnership rather than a true co-tenancy, resulting in a valid mortgage as to the lender's undivided interest.[117] As a result, the parties may agree that it is easier to form a partnership at the outset and avoid the necessity of obtaining a court determination that what they really formed was a partnership instead of the co-tenancy which they apparently formed.

5. *Effect on Title Insurance.* The principal area in which the use of a co-tenancy arrangement to own the project may benefit the parties involves title insurance coverage for known but undis-

116. This technique may not be available to regulated lenders which are subject to limitations on their equity investments in such projects. *See* Federal Home Loan Bank Board Regulations, 12 C.F.R. § 545.9-1 (1980).

117. If the relationship between the developer and lender is deemed to constitute a partnership, the lender would not have a real property interest in the project, but would have a personal property interest in the partnership. *See* TEX. REV. CIV. STAT. ANN. art. 6132b, § 26 (Vernon 1970). There would be no question of failure of consideration as to the partnership, so the mortgage should be valid as to the entire interest in the project owned by the partnership.

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Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

closed title defects. If each of the parties obtains separate title insurance coverage for its respective undivided interest, it may be argued that the knowledge of undisclosed title defects possessed by one of the parties does not affect the title insurance coverage of the other party. The title insurer may contend that the parties actually created a partnership; therefore, the knowledge of one of the parties could be attributed to the other party.[118] It is difficult to see how the title insurer could be successful, however, when it was willing at the outset to insure the parties' undivided interests separately and collect any extra premiums payable for two policies.[119] In addition, the party without knowledge of the undisclosed title defect may argue successfully that the creation of a partnership subsequent to the acquisition of title to the property is not inconsistent with the fact that they originally acquired separate undivided interests in the land which were insured separately. While there may be some question as to the effect of later increases in title insurance coverage to cover the value of the improvements placed on the land, the primary concern of the parties is for losses suffered due to title defects which existed when the land was acquired.

6. *Effect on Admitting Investors.* Whether the parties have created a true co-tenancy or a general partnership for state law purposes, it seems that a co-tenancy arrangement results in problems for both the lender and developer with respect to admitting additional investors. If the parties create a true co-tenancy, additional investors acquiring undivided interests in the project must join in any subsequent conveyance of the project. When the parties inadvertently create a partnership, a conveyance of the project may still require joinder of all of the parties, since title to the project would be held in undivided interests and, ordinarily, no provision would have been made for a majority of the undivided ownership interests to convey the entire project. In addition, there will be great concern over the mutual agency powers which additional investors would have to bind the other inadvertent partners.

118. *See id.* § 12.

119. Under current title insurance regulations, somewhat larger premiums would be required with respect to the first $200,000 in insurance coverage if two policies are issued instead of one. *See* Schedule of Basic Premium Rates for Title Insurance, Basic Manual—Title Insurance in the State of Texas, Section III, R-1. (Hart Graphics, Inc. 1981 Supp.).

As noted previously, if the lender and developer structure their ownership arrangement as a co-tenancy, they should record any applicable restrictions on transfer or rights of first refusal in order to control whether or not additional investors obtain an interest in the project. Even if the co-tenancy were deemed to be a partnership for other purposes, where the parties structured record title to the project as a co-tenancy, it may not be possible for them to successfully argue that the kinds of controls which general partners can exercise over the admission of new partners should also apply to the acquisition of undivided interests in the project.

7. *Summary of Considerations.* While the use of a co-tenancy structure to own the project in an equity participation arrangement may offer some benefits in the area of title insurance, it appears to offer few, if any, other benefits. Such an arrangement may combine significant disadvantages of a true general partnership with comparable disadvantages of a true co-tenancy. Consequently, it seems there are few situations in which a lender and developer would be well-advised to utilize a co-tenancy structure for the ownership of the project in their equity participation arrangement.

D. *Use of a Joint Venture*

The term "joint venture" is used herein simply to refer to a limited purpose general partnership. The only distinction being drawn between a "joint venture" and an entity usually described as a "general partnership" is that a joint venture is formed solely for the purpose of owning and operating a single real estate project and not to engage in the real estate business generally.[120]

1. *Tax Considerations.* The use of a joint venture to own the project results in the same basic tax consequences as a limited partnership for the lender and developer.[121] The use of a general partnership-type vehicle, however, avoids the pitfalls of the classi-

120. *See* Panama-Williams, Inc. v. Lipsey, 576 S.W.2d 426, 431 (Tex. Civ. App.— Houston [1st Dist.] 1978, writ ref'd n.r.e.). *See also* Roegge, Talbot & Zinman, *Real Estate Equity Investments And The Institutional Lender: Nothing Ventured, Nothing Gained,* 39 FORDHAM L. REV. 579, 591 (1971).

121. *See* I.R.C. § 7701(a)(2). A joint venture is named as one of the entities within the Code's definition of a "partnership." *Id. See generally* 1 A. WILLIS, PARTNERSHIP TAXATION §§ 4.05-.06 (1976). The author discusses the "partnership format for a joint venture" (using the term "joint venture" generally as a description of an economic rather than a legal relationship) and concludes that it is a favored approach. *See id.*

Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

fication regulations under which a limited partnership might be treated as an association taxable as a corporation rather than a partnership for tax purposes.[122]

As is the case with a limited partnership, there are a number of tax issues which the lender and developer must resolve in the course of negotiating various aspects of the structure of the joint venture, including the proper classification for tax purposes of mortgage financing provided by the lender. Since these issues may not be directly relevant to the choice of the type of entity to own the project, they are discussed in the context of negotiating the various terms of the equity participation arrangement itself.

2. *Liability Considerations.* One of the principal obstacles to using a joint venture is the liabilities to which the lender and developer are thereby exposed. Although most of these adverse consequences can be eliminated by choosing a subsidiary corporation to own the beneficial interest of each party, this technique is not always satisfactory. In such situations, especially, the parties must be aware of the extent to which the use of a joint venture to own the project may give rise to unanticipated liabilities.

The general rule is that a joint venturer is jointly and severally liable for all liabilities of the joint venture, in the same manner in which members of a true general partnership would be liable. A mutual agency relationship exists between the members of a joint venture similar to that existing in a true general partnership.[123] The objective for using a joint venture, instead of a true general partnership, is to achieve some limitation on the scope of the mutual agency relationship and, consequently, on the extent to which one joint venturer effectively can bind the joint venture and the other joint venturer to third-party liabilities without the consent of the other joint venturer.

When a lender and developer form a joint venture, they typically agree as to various limitations on the authority which each can exercise without the concurrence of the other. Notwithstanding such

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122. *See* Treas. Reg. § 301.7701-3. See text accompanying notes 62-79 *supra*. It is assumed that there would not be any problem in the classification question if a joint venture were used. *See generally* 1 A. WILLIS, PARTNERSHIP TAXATION §§ 1.01-.02, 4.04 (1976 & Supp. 1981).

123. *See* Tex-Co Grain Co. v. Happy Wheat Growers, Inc., 542 S.W.2d 934, 936 (Tex. Civ. App.—Amarillo 1967, no writ) (joint venturer's rights, duties, and liabilities are comparable to those of partners).

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agreed limitations, each venturer will continue to have some degree of apparent authority to bind the joint venture and the other venturer to third parties who do not have actual or constructive notice of the agreed limitations. The extent of this apparent authority depends upon the nature of the liabilities in question and whether the third party acted reasonably in assuming that the joint venturer had authority to undertake such liabilities on behalf of the joint venture and the other venturer.[124]

The use of a joint venture should serve to put third parties on notice that neither of the venturers has authority to undertake liabilities for the joint venture or the other venturer with respect to other real estate projects. Although there is not absolute purity in this regard, it is generally believed that most members of the bar and the business community draw a rather clear intellectual distinction between the concept of a joint venture formed for the purpose of a single real estate project and a true general partnership formed to engage in the business of real estate. When there is confusion in this regard, it seems to prevail on the side of using the term "general partnership" for a single-project endeavor rather than on the side of using the term "joint venture" for a multi-project endeavor. Consequently, if one of the venturers seeks to undertake liabilities unrelated to the project, on behalf of the joint venture and the other venturer, it is unlikely that a third party would be able to enforce such liabilities against the joint venture and the other venturer, unless it can be shown that the other venturer approved or ratified incurring such liabilities, either expressly or by implication.[125]

Determining the extent of the apparent authority of one of the venturers to bind the joint venture and the other venturer to liabilities which are clearly related to the project may be a more difficult task. There is a broad range of activities in which a typical joint venture would be involved. While the determination of the extent of apparent authority may be reasonably easy at each end of this range, it is quite difficult in the middle area. For example, it is fairly easy to determine that one of the venturers in a joint venture

124. *See* Spiritas v. Robinowitz, 544 S.W.2d 710, 717 (Tex. Civ. App.—Dallas 1976, writ ref'd n.r.e.). *See also* 33 TEX. JUR. 2d, *Joint Adventures* § 9 (1962).

125. *Cf.* Southern Coast Corp. v. Natural Gas Pipeline Co., 337 F.2d 158 (5th Cir. 1964) (regarding estoppel of a venturer from asserting that it is not bound).

which owns a garden apartment complex has apparent authority to bind the joint venture and the other venturer to a six-month lease on one of the apartment units in accordance with the standard leasing terms and conditions for the complex. Similarly, it is easy to determine that one of the venturers does not have apparent authority to bind the joint venture and the other venturer to a contract to sell the apartment complex.[126] In between these extremes, however, are a number of activities where a venturer's apparent authority may be more difficult to determine. For example, while the lender and developer may view agreements pertaining to property management and operation of laundry room concessions to be significant and determine that their mutual approval is required for the execution of such agreements, this may not be obvious to third parties. Consequently, one of the venturers may find itself bound to perform an agreement of this type executed by the other venturer without the first venturer's approval.

For the foregoing reasons, lenders and developers should be very careful in choosing the parties with whom they are willing to form a joint venture to own the project in an equity participation arrangement. Notwithstanding the exercise of great care in this regard, there continues to be some risk of exposure to unanticipated liabilities. In the final analysis, however, such exposure may be perceived as an acceptable risk to incur in order to obtain other advantages offered by having the project owned by a joint venture.

3. *Control Considerations.* As between themselves, the joint venturers have virtually unlimited latitude regarding the extent to which they can control the operations of the venture.[127] Since the parties accept exposure to the project's liabilities when they agree to utilize a joint venture, there is no reason to restrict either party from participating in management, as there is with a limited partnership. The use of a joint venture also enables the parties to reach whatever agreement is deemed appropriate regarding the terms and conditions under which the project subsequently may be sold

126. As a conveyance of the project would not constitute carrying on the business of the partnership in the usual way, such act would require authorization by all partners. *See* TEX. REV. CIV. STAT. ANN. art. 6132b, §§ 9-10 (Vernon 1970).

127. *See generally* TEX. REV. CIV. STAT. ANN. art. 6132b, § 18 (Vernon 1980) (general rules prescribed therein as to relationships between partners, including their equal rights in the management and control of the partnership business, are subject to contrary provisions in the partnership agreement).

St. Mary's Law Journal, Vol. 12 [1980], No. 4, Art. 4

or refinanced by one of the parties without the further approval of the other party. This avoids the potential question regarding the enforceability of such an agreement which may exist with respect to a limited partnership.[128] In addition, since the joint venture is not subject to the corporate legal distinctions between actions appropriate for shareholders and actions appropriate for the board of directors, the parties can draw the line wherever they choose between routine, daily activities which can be managed by one venturer and major decisions requiring concurrence of both venturers. The parties may simply agree that all matters will require the concurrence of both venturers. As a practical matter, however, the parties will usually distinguish between day-to-day activities falling within the province of one of the venturers and major decisions requiring mutual concurrence, adopting appropriate guidelines within which the designated venturer is authorized to exercise discretion as to the management of the daily activities.

4. *Effect on Mortgage Financing.* The use of a joint venture to own the project avoids the question which may arise in the context of a co-tenancy arrangement as to the status of the lender's undivided interest upon foreclosure of the mortgage securing the loan by the lender to the co-tenancy.[129] A joint venture arrangement may also solve some of the problems presented by section 14 of the TULPA with respect to mortgage loans made to limited partnerships by limited partners.[130] Section 40 of the Texas Uniform Partnership Act (TUPA) may, however, create other problems with respect to loans made by a lender venturer to its joint venture.[131] The TUPA does not prohibit a lender general partner from receiving collateral security in the property of a general partnership of which it is a member or from receiving payments from an insolvent general partnership. Section 40 of the TUPA provides, however, that upon dissolution the assets of a general partnership available for distribution are to be distributed first to creditors other than partners.[132] Since section 40 of the TUPA does not distinguish between secured and unsecured creditors, it seems that the claims of

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128. See text accompanying note 91 *supra.*

129. See text accompanying notes 112-14 *supra.*

130. *See* TEX. REV. CIV. STAT. ANN. art. 6132a, § 14(a)(1) (Vernon 1970). See text accompanying notes 92-98 *supra.*

131. *See* TEX. REV. CIV. STAT. ANN. art. 6132a, § 40 (Vernon 1970).

132. *See id.* § 40(b)(I).

Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

a partner-creditor of a general partnership whose debt is secured by a mortgage on partnership property would be subordinate to the claims of both secured and unsecured nonpartner creditors. It is difficult to determine, therefore, what protection the mortgage on the project would afford to a lender joint venturer against third-party creditors of the joint venture.

Further analysis indicates that the priority status of the lender joint venturer's loans to the joint venture should have little consequence in the selection of a joint venture to own the project. If the assets of the joint venture are sufficient to satisfy both the third parties' claims against the joint venture as well as the lender's claims, the question of priority of payment is of minimal practical importance. On the other hand, the assets of the joint venture may be insufficient to satisfy all claims. The joint and several liability of the lender joint venturer for unsatisfied third-party claims would result, in that case, in the lender being liable for those claims, subject to a right of contribution from the developer joint venturer, thus negating any advantage which might otherwise be derived from a priority position of the lender's mortgage.

5. *Effect on Title Insurance.* Compared with other forms of ownership arrangements, a joint venture presents the most difficulties for the parties with respect to title insurance. Although knowledge of one of the joint ventures regarding undisclosed title defects acquired prior to the formation of the joint venture might not be attributed to the joint venture if the knowledgeable joint venturer is not responsible for obtaining the title insurance, the importance of the status of title to the property makes this result unlikely.[133] Accordingly, the knowledge of either joint venturer of undisclosed title defects appears to be attributable to the joint venture, with the title insurer being able to avoid liability under the title insur-

133. Under section 12 of article 6132b, it appears that the knowledge of the joint venturer responsible for obtaining the title insurance would be attributed to the joint venture whether acquired before or after the joint venture is formed. That provision also would attribute knowledge of the other joint venturer to the joint venture where the knowledge is acquired after the joint venture is formed. It is not altogether clear whether knowledge acquired by the other joint venturer before the joint venture is formed will be attributed to the joint venture. The language of the statute implies that such previously acquired knowledge should be attributed to the joint venture where the other joint venturer could have communicated the knowledge to the joint venturer responsible for obtaining the title policy, but the comment indicates that this is not the intended result of the statute. *See id.* art. 6132b, § 12 & comment.

St. Mary's Law Journal, Vol. 12 [1980], No. 4, Art. 4

ance policy in the event of a failure of title because of the known but undisclosed title defect.

6. *Effect on Admitting Investors.* Because of the mutual agency relationship implicit in a joint venture, it is with this form of ownership that the parties will be most concerned about procedures for admitting new investors. Since section 18(1)(g) of the TUPA provides that no person can become a partner of a partnership without the consent of all the partners,[134] an agreement is not necessary to prevent one of the venturers from being involuntarily subject to claims arising from the actions of parties with whom the venturer had not agreed to become a partner. The assignability of a partner's interest,[135] however, necessitates an advance agreement as to the extent to which such assignments are to be subject to prohibitions or restrictions, such as rights of first refusal.

7. *Summary of Considerations.* Comparatively, the use of a joint venture as the project ownership vehicle may be the most satisfactory form for both the lender and developer in most situations. A joint venture will provide the same tax benefits as a limited partnership without incurring the risks of inadvertent classification as an association taxable as a corporation. A joint venture will also permit each of the parties to participate fully in the management of the project. The lender, however, will be subject to liabilities to a greater extent than it would be as a limited partner, and its mortgage financing will be less secure than it would be if the project entity were a limited partnership. Moreover, as discussed further below, the developer may prefer to use a limited partnership to avoid reclassification of the mortgage financing as equity capital, even if the developer is willing to allow the lender to participate fully in the management of the project. These concerns which the use of a joint venture raises for the parties may be curable, however, if the lender is able to use a subsidiary to own its interest in the joint venture. In that event, it seems that, although it is not perfect, a joint venture is likely to be the best possible form for achieving the objectives of the parties in a typical equity participation arrangement.

134. *See id.* § 18(1)(g).
135. *See id.* § 27.

Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

IV. Choice of Ownership Arrangement in Project Entity

In addition to deciding what type of entity or structure will be used to own the project, the lender and developer must decide what type of arrangement each of them will use to own its respective beneficial ownership interest in the entity or structure owning the project. Although the considerations involved in these two levels of decision-making have been somewhat arbitrarily separated for purposes of discussion, the two decisions are usually made concurrently and the decision made with respect to one issue will affect, and be affected by, the decision made as to the other issue.

A. *Choice of Ownership Arrangements by Lenders*

1. *Tax Considerations.* If a lender is not prohibited by law or applicable regulatory restrictions from owning its interest in the project entity through a wholly-owned subsidiary rather than directly, such procedure may provide significant benefits for the lender. Obviously, care should be taken to assure that the lender is legally permitted to utilize a subsidiary for this purpose.

A lender using a wholly-owned subsidiary to obtain some of the potential advantages discussed in succeeding portions of this section should not encounter any tax problems if the lender is eligible to file a consolidated corporate income tax return for itself and the subsidiary.[136] Assuming that the project entity is a joint venture, the tax benefits of the ownership of the project would "flow through" the joint venture's tax returns to the wholly-owned subsidiary, and the subsidiary's share of the tax benefits would flow through to the lender-parent by means of the consolidated income tax return filed by the subsidiary and the lender-parent.[137] In this manner, net operating losses realized by the subsidiary from the joint venture may be applied to offset taxable income derived by the lender from its separate activities.[138] Ordinary taxable income realized by the subsidiary from the joint venture is taxed only once as part of the consolidated taxable income of the lender-parent

136. I.R.C. §§ 1501, 1504.

137. Treas. Reg. § 1.1502-11 (1980). The "flow through" effect is a generalization; the validity of which depends upon a number of factors which are beyond the scope of this article.

138. *Id.* § 1.1502-21.

St. Mary's Law Journal, Vol. 12 [1980], No. 4, Art. 4

and the subsidiary.[139] Moreover, operating losses realized by the lender-parent from its separate activities may offset ordinary taxable income realized by the subsidiary from the joint venture during the later years of the project's existence.[140] This reciprocal offsetting procedure and single-tax treatment is also available for capital gains and losses realized by the lender-parent and the subsidiary.[141] Finally, cash flow distributions and proceeds of capital transactions received by the subsidiary from the joint venture are passed through to the lender-parent without double taxation.[142]

If the lender-parent is not eligible to file a consolidated corporate income tax return with the proposed subsidiary, the use of a subsidiary could have materially adverse tax consequences. The lender-parent would not be able to offset losses realized by the subsidiary from the project entity against income from the lender's separate activities. Conversely, the lender-parent would not be able to offset losses from its separate activities against taxable income realized by the subsidiary during the later years of the project's existence. To the extent the subsidiary has taxable income, there would be double taxation on 15% of dividend distributions to the lender-parent.[143] Moreover, tax-free cash flow distributions received by the subsidiary from the project entity which are passed through to the lender-parent at a time when the subsidiary has no earnings and profits would be taxable to the lender-parent to the extent the distributions exceed the lender-parent's basis in the subsidiary's stock.[144] In the event of the sale of the project, if the subsidiary has not been liquidated previously, any capital gain realized with respect to the subsidiary's interest in the project entity would be subject to tax at the subsidiary level and could not be offset by capital losses realized by the lender-parent from its separate activities.[145] Unless the subsidiary is then liquidated, there would also be tax on at least 15% of the amounts distributed by

139. *Id.* §§ 1.1502-11, .1502-12.

140. *Id.* § 1.1502-21.

141. *Id.* §§ 1.1502-11, .1502-22.

142. *Id.* §§ 1.1502-11, .1502-14.

143. I.R.C. § 243 (only 85% of the dividends received are eligible for the deduction); *id.* § 11 (the amount remaining after taking into account the 85% dividends received deduction, or 15%, would be subject to taxation at both the lender-parent and subsidiary levels).

144. I.R.C. § 301(c)(3).

145. In the situation discussed, there would be no consolidation of income or losses of the lender-parent and subsidiary.

the subsidiary to the lender-parent as a result of the sale of the project.[146]

2. *Liability Considerations.* One of the principal reasons why a lender may prefer to use a subsidiary to own its beneficial interest in the project entity is the degree to which this technique would insulate the lender's separate assets and activities from liabilities arising out of the operations of the project and the project entity. This limitation of liability is not ordinarily acceptable to the developer with respect to liabilities of the lender to the developer; thus, the lender is usually required to guarantee the performance of the subsidiary's obligations to the developer. Such guarantee would not ordinarily extend, however, to unauthorized obligations to third parties.[147] The lender's limitation of liability is also eroded to the extent that it uses the same subsidiary to engage in a number of equity participation arrangements. Beyond the assets of the subsidiary and the limited scope of the lender's guaranty of performance to the developer, however, the use of a properly organized and maintained subsidiary to own the lender's beneficial interest should insulate the lender's separate assets and activities from liabilities arising out of the operations of the project and the project entity.

3. *Effect on Mortgage Financing.* The lender may want to consider the use of a subsidiary to attempt to resolve some of the lender's potential problems under the TULPA and the TUPA with respect to mortgage financing which it provides for the project. Assuming that the legal requirements for obtaining recognition of the subsidiary as a separate corporation have been satisfied, the lender may be able to avoid the problems regarding loans by partners if it utilizes the subsidiary to be the partner in the project entity and provides the mortgage financing to the project entity directly.[148]

146. See note 143 *supra*. In the event the subsidiary is liquidated, the lender-parent presumably would not recognize gain or loss by reason of I.R.C. section 332.

147. A lender which would otherwise be reluctant to utilize a joint venture as the project entity may be willing to do so if the lender's subsidiary owned the joint venture interest. Presumably, the developer would require a guarantee from the lender for the obligations of the subsidiary. Likewise, it would appear that the parties would desire to cross-indemnify each other for, among other things, liabilities incurred outside the scope of their authority or in violation of the joint venture agreement.

148. The assumption is made that there will not be, for state law purposes, any question regarding the separate existence of the lender-parent and its subsidary. *See generally* Roegge, Talbot & Zinman, *Real Estate Equity Investments And The Institutional Lender:*

St. Mary's Law Journal, Vol. 12 [1980], No. 4, Art. 4

There does not appear to be any basis within the TULPA and the TUPA to negate the legal distinction between the lender and its subsidiary in an arrangement such as this, resulting in treatment of them as a single entity for purposes of imposing the restrictions of the TULPA and the TUPA regarding loans by partners with respect to the mortgage financing provided by the lender to the project entity. Since the subsidiary, and not the lender, is the named member of the project entity, it is improbable that a third party could successfully contend that it had been misled into believing that the mortgage financing provided by the lender constituted a loan to the project entity by a partner.[149] On the other hand, since the lender does not have the status of a partner for any other purpose, it is difficult to determine how either the TULPA or the TUPA could be interpreted to make the lender a partner solely for the purpose of imposing these restrictions.

4. *Summary of Considerations.* Certain lenders are prohibited by law from utilizing a subsidiary to own their beneficial interest in project entities. Other lenders are ineligible to file consolidated corporate income tax returns with their subsidiaries and may be unwilling or unable to absorb or avoid the unfavorable tax consequences of being required to file separate tax returns. A lender which does not face these problems, however, should consider the use of a subsidiary to own its beneficial interest in the project entity in order to achieve the advantages of limitation of liability and avoid the problems created when mortgage financing provided by the lender is treated as a loan by a partner.

B. *Choice of Ownership Arrangements by Developers*

The typical developer is usually less interested in the advantages which might be obtained by utilizing a separate entity to own its interest in the project than it is in determining whether its principal officers and shareholders can participate individually in the economic and tax benefits which may result from their owning an interest in the project entity. This objective often leads a developer to consider the possible advantages and disadvantages of creating a partnership between itself and its principals to own the interest

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Nothing Ventured, Nothing Gained, 39 FORDHAM L. REV. 579, 618-20 (1971).

149. *See* Associates Dev. Corp. v. Air Control Prods., Inc., 392 S.W.2d 542, 544-45 (Tex. Civ. App.—Austin 1965, writ ref'd n.r.e.).

Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

which the developer would otherwise own in the project entity.[150] Discussed below are some of the considerations which should be taken into account by a developer in determining whether to own its interest in the project entity directly, through a corporate subsidiary, or through a developer-partnership with its principals. Since the issues involved in the concept of utilizing a developer-partnership in a real estate transaction are not limited to equity participation arrangements with institutional lenders, a complete discussion of this topic is beyond the scope of this article.[151] The following, therefore, is an attempt to call attention to some of the major issues which should be resolved in connection with developer-partnerships.

1. *Tax Considerations.* It should not be particularly significant to the developer whether it owns its interest in the project entity directly or through a wholly-owned subsidiary. Assuming that the developer and its subsidiary are able to file a consolidated corporate income tax return, the tax results are substantially the same for the developer in both instances. For this reason, if other advantages can be obtained by using a subsidiary to own the interest in the project entity, tax consequences should not be prohibitive.

When a developer and its principals are considering the formation of a developer-partnership to own the interest which the developer would otherwise own in the project entity, the primary tax concern is the extent to which the principals may be deemed to have realized taxable income as a result of the developer's activities in connection with the project. For example, assume that the developer and its principals form a limited partnership to own the interest which would otherwise be owned by the developer in the project entity, that the developer is the sole general partner and the principals are the limited partners, and that the developer owns 50% of the limited partnership and the principals own the

150. The term "developer-partnership" is used in the text to refer to the relationship created between the developer and its principals. The developer-partnership is assumed to be a general or limited partnership.

151. The developer and its principals must consider a number of issues in the process of making any decision in this regard. For example, a critical issue that must be addressed and resolved involves the implications of the "corporate opportunity" doctrine if the principals do not constitute all of the shareholders of the developer. The parties also must determine, among other things, the extent to which the principals will be liable for the obligations of the developer-partnership and the impact any limitations thereon may have on the tax effects of the relationship.

other 50%. If the developer-partnership is obligated to the lender to provide funds to the project entity to the extent necessary to defray construction cost overruns and operating deficits, and the principals are not required to contribute their proportionate share of such funds to the developer-partnership, the argument could be made that the principals have realized taxable income as a result of the performance by the developer of the developer-partnership's obligations.[152] The amount of taxable income realized by the principals might be limited to the 50% of the funds required which the developer provided in their stead, or it might consist of the value of the principals' interest in the developer-partnership at the time the developer performs such obligations. The income so realized by the principals might be characterized as compensation subject to the maximum tax on earned income or, when the principals are shareholders of the developer, it might be characterized as dividends subject to the maximum tax on unearned income.[153] In any event, it is likely that the Service would take the position that the principals had realized taxable income in some amount and character as a result of the developer's performance of the developer-partnership's obligations. This result is even more likely where the developer-partnership is formed after the project is completed and the developer has performed substantially all of its obligations to the lender.[154]

Several guidelines should be followed by the developer and its

152. The risk in this situation is that the Service would claim that the corporate funds of the developer had been diverted to the personal use of the principals, because the developer provided funds needed by the developer-partnership to satisfy its obligations with respect to, and preserve its interest in, the project. To the extent the developer provides such funds in excess of its proportionate ownership interest in the developer-partnership, the argument could be made that the developer has satisfied liabilities of the principals, see Wortham Mach. Co. v. United States, 521 F.2d 160 (10th Cir. 1975); or that the developer has diverted corporate funds for the personal benefit of the principals. *See* Kuper v. Commissioner, 533 F.2d 152 (5th Cir. 1976) *(rev'g* 61 T.C. 624 (1974)). *See generally* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 7.05 (1979 & Supp. 1980).

153. *See* I.R.C. § 1348. Earned income does not include amounts received which represent a distribution of earnings and profits from a corporation rather than a reasonable allowance as compensation for personal service actually rendered. *Id.* § 911(b).

154. *See generally* 1 W. MCKEE, W. NELSON & R. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶¶ 5.02, .05-.06 (1977 & Supp. 1980). It is unclear what the amount of income would be, particularly when the interest received is an interest in profits only or in capital and profits. *Id.*

Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

principals in organizing and operating a developer-partnership in order to minimize such tax problems. The developer-partnership should be formed at, or prior to, the formation of the project entity and the commencement of construction of the project. Preferably, the developer-partnership should be the entity which initially contracts to purchase the land on which the project is built. The developer-partnership should be organized in a manner which will enable it to participate in several projects.[155] Such organization would give economic substance to the ability of the developer-partnership and its individual partners regarding performance of its (and their) obligations with respect to the project and under the contract to purchase the land for the project. Finally, the obligations of the developer and its principals to provide funds required by the developer-partnership to fulfill its obligations to the project entity should be proportionate to their respective interests in the developer-partnership.

Assuming that the problems described above can be surmounted, the use of a developer-partnership to own what would otherwise be the developer's interest in the project entity can be of significant benefit to the developer's principals. During the early years of the project's existence, the developer's principals would be able to offset their share of the tax losses generated by the project against their other income and would benefit from the receipt of their share of the tax-sheltered cash flow from the project without incurring the tax on dividends or compensation which would be payable if the cash flow distributions were initially received by the developer and then paid to the principals.[156] During the later years of the project's existence, taxable income generated by the project would not be subject to double taxation at both the developer and principal level.[157] Further, in the event of the sale of the project, the principals' share of the profits realized as a result of the sale could be received directly by the principals without double taxation.[158] In many cases, the profits received by the principals would be treated as long-term capital gains subject to more favorable tax

155. Preferably, the developer-partnership also would have substantial capital and would not attempt to limit the liability of the principals.

156. See text accompanying notes 59-60 *supra*.

157. *See* I.R.C. § 702. See text accompanying notes 26-40 *supra*, for a discussion of some of the tax consequences of holding the interest in the corporate form.

158. *See* I.R.C. § 702.

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St. Mary's Law Journal, Vol. 12 [1980], No. 4, Art. 4

rates than would be applicable if the profits were received as additional compensation to the developer's principals in an effort to avoid double taxation at both the developer and principal level.[159] Obviously, these potential tax advantages of a developer-partnership are substantial and justify consideration of the use of a developer-partnership in most situations.

2. *Liability Considerations.* The principal reason why a developer should consider owning its interest in the project entity through a subsidiary is to achieve some degree of limitation of liability with respect to obligations arising out of the operations of the project entity. Although the lender will probably require that the developer guarantee the performance of the subsidiary's obligations to the lender, including contribution obligations, the use of a subsidiary insulates the developer from claims based on unauthorized obligations to third parties. It should be noted, however, that the lender customarily looks to the developer to be responsible for the daily management of the project entity and, for this reason, may be unwilling to give the developer the opportunity to limit its liability in this manner by using a subsidiary.

Potential liability is of great concern to the principals of the developer in connection with the question of whether to form a developer-partnership to own the interest which the developer would otherwise own in the project entity. As previously noted, however, serious tax consequences can result if the liabilities of the principals with respect to the developer-partnership are more limited than those of the developer. Thus, while it may not be necessary that the principals have unlimited liability with respect to obligations of the developer-partnership to the lender, any limitations on such liability should also apply to the developer.

There are a number of third-party liability areas where it is impossible to achieve effective limitation of the principals' liabilities if a developer-partnership is utilized to own the interest in the project entity. Although insurance can be obtained which affords some degree of protection, there is always the possibility that the princi-

159. *See id.* § 1202 (providing for a 60% deduction for capital gains); *id.* § 1348 (providing for a 50% maximum tax on personal service income). Even if the principal's marginal rate were the maximum of 70%, the effective rate on a capital gain would be 28%. Also, it would not be necessary to adopt a plan of complete or partial liquidation of the developer or incur the risk of paying unreasonable compensation to the developer's principals to avoid double taxation.

Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

pals will incur some liability for third-party contract and tort claims. This potential liability extends to mortgage financing provided by the lender joining in the equity participation arrangement to the extent that such financing is not secured solely by the project. The possibility of incurring such liabilities should be weighed carefully by the principals when considering the economic and tax benefits which they might obtain individually through utilization of the developer-partnership.

In order to limit their liability and avoid the possible inadvertent receipt of taxable income, some principals may prefer to structure the developer-partnership in a manner which requires that the developer alone assume certain risks for which it is duly compensated. For example, in many equity participation arrangements, the developer and its principals expect profits to be generated not only as a result of their ownership interest in the project but also in connection with the development of the project. For instance, the lender may be willing to allow the developer to make a profit on the development of the project reflecting the anticipated value which the lender will own in the equity of the project upon completion. Since the appraised value of the completed project is often significantly greater than the cost of development and construction of the project, the potential development profit may be substantial. When development profits are paid to the principals through the developer-partnership, there may be reason for concern that the principals will not retain their share of the funds for purposes of recontribution to the developer-partnership if required to cover future liabilities. Some principals may be willing, therefore, to forego their share of the development profits and agree that the entire amount be paid to the developer. In exchange for this agreement, the developer would provide the first funds required by the developer-partnership to fulfill its obligations with respect to cost overruns and operating deficits of the project up to the amount of the development profits initially received by the developer. The principals would be obligated to contribute additional funds only after the developer has recontributed to the developer-partnership either the entire amount of the development profits or the portion which the principals would otherwise have received through the developer-partnership. Conversely, if the amount required by the developer-partnership to fulfill its obligations with respect to the project is less than the development profits initially

St. Mary's Law Journal, Vol. 12 [1980], No. 4, Art. 4

received by the developer, the excess development profits would belong entirely to the developer.

It is not entirely clear that this technique of limiting the liability of the developer's principals avoids the possible tax problems discussed in the preceding section. It is probably ineffective when it is ascertainable at the outset that the potential amounts required by the developer-partnership to defray future liabilities regarding the project will equal or exceed the development profits, so that it is unlikely that the developer will be able to retain any portion of the development profits. When it appears reasonably certain, however, that the developer will be able to retain a significant portion of the development profits in excess of the share it otherwise would have received through the developer-partnership, this technique not only provides some degree of protection from liability for the developer's principals but may also avoid potential tax problems.[160]

Although not directly related to a particular equity participation arrangement, there is another liability consideration which should be taken into account by the developer and its principals in deciding whether to use a developer-partnership. To the extent that the profits generated by the project are passed through to the principals by means of using a developer-partnership, such profits are not available to the developer for further investment or debt reduction, and are not reflected in its financial statements. Consequently, the financial strength of the developer is not improved. This factor may postpone the time when the developer will have achieved sufficient financial strength that lenders and other third parties are willing to extend financing to, and otherwise contract with, the developer without the assurance of the principals' personal guarantees of the developer's performance of its obligations. For this reason, the developer's principals will often conclude that it is prudent to have the developer retain a substantial interest in the developer-partnership, so that the developer will have an opportunity to receive and utilize a substantial portion of the profits of the project to improve its financial strength, notwithstanding

160. The problems discussed in the text accompanying notes 152-55 *supra*, may arise because the developer did not receive any benefit from the payments it agreed to make on behalf of the principals. If the developer receives a benefit for such undertaking, however, the fact that such payments were made may not result in income to the principals. *See* Sammons v. Commissioner, 472 F.2d 449, 453 (5th Cir. 1972) (no constructive dividend unless primarily for shareholder purposes rather than corporate purposes).

Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

other considerations that might lead to the conclusion that the principals should have a more substantial interest in the developer-partnership.

Finally, the developer itself may be concerned about the extent to which the use of a developer-partnership may expose the developer to unanticipated liabilities. Assuming that a general partnership is used in order to avoid potential tax problems for the principals, a mutual agency relationship will exist between the developer and each of the principals participating in the developer-partnership. Although the principals are customarily officers of the developer who possess actual or apparent authority to bind the developer to liabilities, there may be some instances in which the developer would have even greater exposure to unanticipated liabilities as a result of the mutual agency and apparent authority of a principal who is a partner in a developer-partnership.[161]

3. *Control Considerations*. There is some diffusion of control over the interest which the developer would otherwise own in the project entity where the developer forms a developer-partnership to own that interest. An individual principal of the developer has separate rights as a partner of the developer-partnership from those the same individual principal would have as an officer of the developer. An individual principal of the developer is also subject, theoretically, to less control as a partner of the developer-partnership than the same individual would be as an officer of the developer. These distinctions ordinarily are not of significant practical concern, since an individual principal of the developer usually desires to cooperate with the developer in order to protect the individual's employment status with the developer. For these reasons, however, the developer should have the right to repurchase the individual principal's interest in the developer-partnership in the event the individual's employment with the developer is terminated. Such an arrangement does not appear to be particularly troublesome, but care should be taken that the individual principal's interest is purchased at a fair value. Otherwise, the position could be taken that the benefits received by the individual from the developer-partnership during the period the individual was

161. For example, a partner's authority to bind the partnership goes beyond the authority of an officer of a corporation to bind the corporation. *Compare* TEX. REV. CIV. STAT. ANN. art. 6132b, § 9 (Vernon 1970) *with* TEX. BUS. CORP. ACT ANN. art. 2.42 (Vernon 1980).

St. Mary's Law Journal, Vol. 12 [1980], No. 4, Art. 4

employed by the developer did not result from a true ownership interest in the developer-partnership, but represented compensation or dividends paid indirectly by the developer to the individual principal.[162]

4. *Summary of Considerations.* The developer is usually satisfied to own its interest in the project entity directly. If a developer wants to have such interest owned by an intervening subsidiary corporation, and the lender is willing for the developer to do so, that procedure should not present materially adverse tax consequences for the developer and does provide some limitation of liability. It is also possible for the developer to utilize a developer-partnership comprised of the developer and certain of its principals. The use of a developer-partnership, however, should be scrutinized carefully because it does present some potential tax, liability, and control concerns for the developer and its principals.

V. Analysis of Individual Equity Participation Arrangements

The final major structural decision which the lender and developer must make in formulating their proposed equity participation arrangement is the selection of the type of equity participation arrangement they will utilize. The choice between an initial ownership, a convertible mortgage, and a purchase option arrangement is made concurrently with the choice of the form of project entity and the methods by which the lender and developer will own their respective interests in the project entity. The lender and developer should take into account certain general considerations in choosing among these three basic types of equity participation arrangements. Following a preliminary discussion of these issues, a number of the considerations which the parties should take into account in negotiating various terms of their proposed equity participation arrangement are addressed. Certain terms of the agreement are not discussed in detail, as they have been covered in the foregoing text.

162. If the principal is not allowed to benefit from increases in the value of his interest in the developer-partnership, or to suffer from decreases in such value, it is difficult to conclude that there is a true ownership status with respect to the principal's interest in the developer-partnership. In that event, the developer-partnership could be construed as merely a conduit for the payment of dividends or additional compensation to the principal.

Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

A. *General Considerations*

Each of the three basic types of equity participation arrangements ultimately will result in a joint ownership arrangement between the lender and developer. Accordingly, the choice between an initial ownership arrangement and either a convertible mortgage or a purchase option arrangement is actually a matter of the timing as to when the lender becomes a joint owner of the project. Nevertheless, this choice is of significant importance to both the lender and developer.

1. *Tax Considerations.* Tax considerations play a major role in determining the most appropriate type of equity participation arrangement. If the lender wishes to participate in the tax benefits generated by the project during the early years of its existence, it will be necessary to utilize an initial ownership arrangement. Conversely, if the parties have agreed that the developer is to enjoy all of the tax benefits generated by the project during the early years, they may prefer to use a purchase option arrangement to assure such a result. By using the purchase option arrangement, the parties may be able to circumvent the difficult problems involved in creating a workable special allocation formula within an initial ownership arrangement and avoid a characterization of the lender's putative debt as an equity contribution within either an initial ownership arrangement or a convertible mortgage arrangement.

Lenders are willing, in many instances, to allow the developer to take advantage of the tax benefits which are generated by the project during the early years of its existence, because the lender has a low effective tax rate or does not wish to report losses on its financial statements. In many situations, therefore, tax considerations will influence the parties to use a purchase option arrangement.

2. *Liability Considerations.* Unanticipated liabilities cause the parties most concern during the early years of the project's existence. This is the period when construction cost overruns can occur and operating deficits are most often experienced as efforts are made to achieve stabilized rentals for the project. It is also the time when the value of the project is at its lowest ration in com-

St. Mary's Law Journal, Vol. 12 [1980], No. 4, Art. 4

parison to its potential liabilities.[163] Consequently, a lender may prefer to provide only mortgage financing for the project at the outset, within the context of either a convertible mortgage or a purchase option arrangement. A developer, however, often resists this effort on the part of the lender, in order to reduce the developer's exposure to the risk of construction cost overruns and operating deficits during this period.

A compromise which may be reached is for the lender to provide a generous amount of mortgage financing for the project, attempting to protect the developer against potential risks. This technique is limited for many lenders, though, as the amount of mortgage financing provided by a regulated lender is typically restricted to a specified percentage of the appraised value of the project.[164] Moreover, the developer is unlikely to be satisfied entirely with this technique, since the debt service on the mortgage financing provided by the lender is a mandatory charge against the revenues of the project, while the return on equity financing is usually a charge against the net cash flow of the project, payable only to the extent available.

The resolution which the parties should reach is difficult to predict. In some situations, the lender is willing to incur the potential liabilities of participating in an initial ownership arrangement in order to obtain tax or other advantages. In other situations, particularly where several lenders are competing to participate in a particular project, the developer may be able to persuade at least one lender that the potential liabilities of an initial ownership arrangement are minimal.

3. *Control Considerations.* An initial ownership arrangement achieves maximum control for the lender over the construction and operation of the proposed project. Although mortgage financing instruments traditionally have allowed lenders to exercise substantial control over certain matters, such instruments leave a number of items to the discretion of the developer. Developers can be expected to resist attempts by lenders to achieve the control of a joint owner without incurring commensurate risks. In addition, a lender exercising the control of a joint owner from the beginning of

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163. Because of this, the project does not serve as any meaningful "buffer" between third parties and the separate assets of the developer and lender.

164. *See* Tex. Sav. & Loan Comm'n Rule 08.00.003.

Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

an equity participation arrangement structured as a convertible mortgage or purchase option arrangement may be held liable as a joint owner.[165] Consequently, if the lender wishes to extend its control over the project beyond that conferred by traditional mortgage financing instruments, it is likely that the parties will structure the proposed transaction as an initial ownership arrangement.

4. *Effect on Mortgage Financing.* A lender may wish to structure the proposed equity participation arrangement as a convertible mortgage or purchase option arrangement in order to avoid or limit some of the problems with regard to loans by partners under the TULPA and the TUPA. If the lender provides mortgage financing for the project when it has no ownership interest, it could be argued that the restrictions of the TULPA and the TUPA regarding loans by partners would not be applicable, even if the lender subsequently acquired an ownership interest in the project.[166] This argument might be particularly persuasive with respect to section 14 of the TULPA, which prohibits the granting of collateral security to a limited partner, because that provision appears to focus on the status of the lender at the time the loan is made.[167]

The provisions of the TULPA and the TUPA which restrict loan payments to partners create more concern since those provisions may be construed to refer to the status of the lender at the time payment is made on the loan, rather than the status of the lender

165. *Cf.* TEX. REV. CIV. STAT. ANN. art. 6132b, § 7 (Vernon 1970) (regarding rules for determining existence of a partnershp); *id.* § 16 (regarding partnership by estoppel). For a discussion of the consequences of such a finding, see text accompanying notes 80-91 (regarding limited partnerships), notes 207-10 (regarding co-tenancies), and notes 123-26 (regarding joint ventures) *supra.*

166. Since the lender would not be in the status of a partner at the time the loans were made, the statutory provision arguably would not apply under their terms. With respect to the problems caused by the TULPA, the provisions of section 14 should not apply for the reason stated. Also, section 24(a)(1) would not appear adversely to affect that argument. TEX. REV. CIV. STAT. ANN. art. 6132a, §§ 14, 24 (Vernon 1977). With respect to the TUPA, however, the same considerations apply as are noted in the text accompanying note 132 *supra.*

167. The argument would appear to be even stronger if section 14 of the TULPA is held to prohibit the granting of collateral security to a limited partner only if the limited partnership is insolvent at the time it is granted. In that event, the lender might want to provide only mortgage financing at the outset when the greatest danger exists that the limited partnership would be held to be insolvent, and to acquire a limited partnership interest only after the project is completed and operating, and it is clear that the partnership is solvent.

at the time the loan is made.[168] This result is most likely in the context of a joint venture subject to the TUPA, since the TUPA makes loans by partners subordinate to other creditors.[169] Under the TULPA, secured loans by a limited partner are on at least a parity with general creditors.[170] The somewhat different policy implications of this fact may justify a conclusion that the restrictions of section 14 of the TULPA do not prohibit payments by a limited partnership on a loan made by a lender prior to becoming a limited partner, notwithstanding the subsequent insolvency of the limited partnership and admission of the lender as a limited partner. Since the lender was not a limited partner when the loan was made, and its right to become a limited partner was not necessarily public knowledge, other creditors should not have been misled as to the status of the loan. Even if the lender's right to become a limited partner was a matter of public record or public knowledge, there was no assurance that the lender would exercise this right. The same reasoning could justify a conclusion that a loan made by a lender before it became a limited partner should not merit the same treatment as a loan made by a lender limited partner, and should, therefore, be accorded priority over, and not parity with, the claims of general creditors of the partnership. The success of this argument in the context of a project entity organized as a limited partnership results in a significant benefit to a lender which is able to sustain its position as a limited partner, since the lender would not be liable for the claims of unsatisfied creditors.

As a result, a lender may wish to structure the proposed equity participation arrangement as a purchase option or convertible mortgage arrangement. Although it is not certain that such an arrangement would preserve the priority of the lender's mortgage on the project and avoid the prohibitions of section 14 of the TULPA, a persuasive case can be made that this result is appropriate.

5. *Summary of Considerations*. In some respects, a lender is in a more favorable position when a proposed equity participation arrangement is structured as a convertible mortgage or purchase op-

168. TEX. REV. CIV. STAT. ANN. art. 6132a, § 24(a)(1) & art. 6132b, § 40 (Vernon 1970).

169. *Id.* art. 6132b, § 40. Again, however, this should have little or no practical effect because of the joint and several liability of the lender as a member of the joint venture. See text accompanying notes 129-32 *supra*.

170. See text accompanying notes 96-97 *supra*.

Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

tion arrangement. In certain instances, however, the lender may desire to structure the transaction as an initial ownership arrangement, or be willing to do so at the insistence of the developer.

B. *Analysis of Initial Ownership Arrangement.*

In an initial ownership arrangement, the lender and developer own an interest in the project and the project entity from the outset. Many of the issues they need to resolve in structuring their agreement will be affected by this fact. Some of the issues which should be resolved in fashioning this type of equity participation arrangement are discussed below.[171]

1. *Determining Ownership Percentages and Debt/Equity Ratio.* Determination of the relative ownership percentages of the lender and developer in their proposed initial ownership arrangement and the relative amounts of construction financing and equity financing to be provided for the project are matters of business negotiation which the parties usually resolve before seeking the assistance of their respective counsel. These determinative factors are largely beyond the scope of this article. Although the parties may have considered some of the other issues discussed below, prior agreement on such issues is not common and the assistance of counsel is usually needed in reaching a complete agreement.

2. *Capital Contribution Responsibilities.* While the amount of equity financing initially provided by the lender for its ownership interest in the project may be determined, the timing of such contribution and the responsibilities for providing additional equity financing are often unsettled. In some cases, the lender may provide all of its initial capital contribution upon commencement of construction in order to: (1) reduce interest costs on the construction loan for the project; (2) meet the security requirements of the construction lender; (3) cover costs which cannot be covered by the construction loan; or (4) allow the developer the use of the funds during the construction period. In other instances, the lender may be unwilling to provide its capital contribution until the project is

171. For additional considerations, see Nellis, Christy & Browne, *Selective Checklist for Negotiating and Drafting a Real Estate Joint Venture Agreement*, in REALTY JOINT VENTURES: PENSION FUNDS—INSTITUTIONAL INVESTORS—DEVELOPERS 73 (Practicing Law Institute 1980); Roulac, *Structuring the Joint Venture*, MERGERS & ACQUISITION, Spring 1980, at 4-14.

St. Mary's Law Journal, Vol. 12 [1980], No. 4, Art. 4

completed or a certain occupancy level has been achieved. Although these decisions are a matter of business negotiation between the developer, the lender, and the construction lender, there are certain tax consequences which should be kept in mind by the parties in negotiating an agreement on these issues.

When the lender does not participate in tax losses generated by the project during the construction period, the timing of payment of the lender's capital contributions will not be important to the lender. On the other hand, if the lender participates in such losses, the timing of payment of the lender's capital contributions can be of great significance.

In order to obtain current deductions for losses generated by the project during the construction period, the lender must have a basis in its interest in the project entity during this period.[172] The lender can obtain a basis by contributing capital to the project entity during the construction period.[173] When the lender and developer have joint and several liability for the payment of the construction loan, the lender's basis is equal to a percentage of the construction loan which is the same as the lender's percentage of sharing losses of the project entity.[174] If neither the developer nor lender assume liability for the construction loan, the lender's basis is equal to the percentage of the construction loan which is the same as the lender's percentage of sharing income of the project entity.[175]

Often the lender will insist that it have no liability for the payment of the construction loan and the developer solely will be liable for the loan. In such instances, the lender can obtain a basis in its interest in the project entity only by actually contributing capital to the project entity or agreeing to make future capital contributions which will be available for the payment of the construction loan.[176] There is a serious question, however, as to whether the amounts which the lender has agreed to contribute can be included in the lender's current basis if the lender's obligation to make such

172. *See* I.R.C. § 704(d).

173. *See id.* §§ 705, 722.

174. *See id.* § 752(a); Treas. Reg. § 1.752-1(e).

175. I.R.C. § 752(c); Treas. Reg. § 1.752-1(e).

176. I.R.C. § 752(e); Treas. Reg. § 1.752-1(e). While the regulation specifically applies only to a limited partner, there appears to be no reason why the same result would not be obtained in the situation discussed in the text.

Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

contributions is conditioned on the completion of the project or the achievement of certain occupancy standards.[177] For this reason, a lender desiring to participate in tax losses generated during the construction period, but unwilling to make its entire initial capital contribution at the outset or accept any liability for payment of a construction loan for which the developer is liable, should make annual contributions in an amount equal to its share of the tax losses for each year or agree unconditionally to make capital contributions on or before the anticipated completion of construction in an amount equal to its estimated share of the construction period tax losses.

The recent Fifth Circuit decision in *Battelstein v. IRS*[178] suggests an additional reason for the lender to make a substantial portion of its initial capital contributions to the project entity during the construction period. This decision seems to establish that capital contributions are required to pay construction period interest on a construction loan in order for the interest to be deducted currently by either the lender or developer.[179] Accordingly, the careful developer should insist that the lender make a portion of its agreed capital contributions during the construction period in an amount at least equal to the estimated amount of interest to be paid on the construction loan. This technique is also important to the lender when it participates in the construction period tax losses.[180]

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177. *See* Treas. Reg. § 1.752-1(e); 1 W. McKee, W. Nelson & R. Whitmire, Federal Taxation of Partnership and Partners ¶ 8.03 (1977). Since future contributions may not be required for payment of the construction loan unless the developer fails to complete the project or fails to achieve certain occupancy standards, and since the lender will not be obligated to make the future contributions until and unless the same conditions are met, it is difficult to determine how such future contributions can be deemed to be available for satisfaction of the construction loan for purposes of giving the lender a current basis in its interest in the project entity in order to enable it to deduct losses during the construction period.

178. *See* 80-2 U.S.T.C. ¶ 9840 (5th Cir. 1980).

179. *See id.* The court cited Burgess v. Commissioner, 8 T.C. 47 (1947), which previously has formed the basis for the deductibility of interest which is, in effect, funded by the loan, but refused to apply the *Burgess* reasoning to the facts in *Battelstein.* By so doing, the court seems to require complete separation of the interest payment and the loan with respect to which it is paid.

180. See note 177, *supra.* The parties presumably would want the lender's equity contribution to be used in the project as quickly as possible to avoid additional construction period interest. In light of the *Battelstein* case, however, it would appear safer to keep enough of the lender's contribution out of the project in order to fund interest payments during the construction period. *See* Battelstein v. IRS, 80-2 U.S.T.C. ¶ 9840 (5th Cir. 1980).

St. Mary's Law Journal, Vol. 12 [1980], No. 4, Art. 4

In most instances the developer does not make substantial capital contributions to the project entity at the outset. It is anticipated that the lender's capital contributions, combined with the proceeds of the construction loan, will be sufficient to develop and construct the project and cover operating deficits for a period of time after completion of construction. The parties often agree that the developer is obligated to contribute any additional capital necessary to complete the construction of the project and to cover operating deficits experienced during a specified period of time after completion of construction.

3. *Construction Financing and Construction Period Losses.* In some situations, the lender agrees to provide both construction and permanent mortgage financing for the project. In most instances, the developer obtains third-party construction financing for the project, and the participating lender agrees to provide, or obtain, permanent mortgage financing upon completion of the project.

If the participating lender provides construction financing for the project, the developer's deductible tax losses during the construction period may be limited to the developer's capital contributions to the project entity during the construction period. This result occurs when the construction financing provided by the lender is considered to constitute an equity capital contribution.[181] In that event, the developer's basis in its interest in the project entity for purposes of deducting losses is limited to its actual contributions.

Under the general entity theory of the Code, loans by a partner to its partnership are treated as loans by outsiders[182] except to the extent that such loans are treated as "transfers of money or property by a partner to a partnership as contributions" in accordance with the requirement that "[i]n all cases, the substance of the transaction will control."[183] Revenue Ruling 72-135[184] and Revenue Ruling 72-350[185] illustrate two situations where the Service held that putative loans by partners should be treated as equity contri-

181. *See generally* 1 W. McKee, W. Nelson & R. Whitmire, Federal Taxation of Partnerships and Partners ¶ 7.02[2] (1977). In this situation, there would be no liabilities for the developer to share in under section 752 because of the re-characterization of the loan as equity.

182. *See* Treas. Reg. § 1.707-1(a).

183. *Id.*

184. 1972-1 C.B. 200.

185. 1972-2 C.B. 394.

Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

butions and, consequently, that such loans could not be included in the basis of the other partners. These rulings have been characterized as overly broad, and as evidencing an attempt by the Service to expand the "thin partnership" doctrine to the tax-shelter area.[186] Nevertheless, these rulings might be considered applicable to an equity participation arrangement.

The "thin partnership" doctrine is discussed extensively in the Tax Court opinions in *Curtis W. Kingbay*[187] and *Joseph V. Hambuechen.*[188] As stated in *Curtis W. Kingbay,* the question as to whether a loan by a partner to a partnership is to be treated as debt or equity is to be answered on the basis of a number of factors:

> [W]hether a particular transaction creates a valid debtor-creditor relationship or is in reality a contribution to capital is a question of fact to be determined from all the surrounding circumstances with the burden of proof on the taxpayer. Such factors as the adequacy of the capitalization of the debtor, the issuance of notes, provision for and payment of interest, presence or absence of a maturity date, intention to repay, whether the debt is subordinated to claims of outside creditors, presence or absence of security for the loan, reasonableness of expectation of repayment, use to which the funds were put, are among those to be considered in making the determination.[189]

Most of the factors listed in the foregoing quotation will be present with respect to mortgage financing provided by lenders in connection with equity participation arrangements. One factor which may be of concern is the extent to which the mortgage financing may be subordinated to the claims of other creditors by operation of the provisions of the TULPA and the TUPA. Another factor which may be of concern is the extent to which the mortgage financing is non-recourse financing secured only by the project. If the mortgage financing is subordinated to the claims of the other creditors of the project entity and is nonrecourse, it seems that an argument could be made that the mortgage financing is at the risk

186. *See* 1 W. McKee, W. Nelson & R. Whitmire, Federal Taxation of Partnerships and Partners ¶ 7.02, at 7-10 (1977).
187. 46 T.C. 147, 154 (1966).
188. 43 T.C. 90, 98-99 (1964).
189. Kingbay v. Commissioner, 46 T.C. 147, 154 (1966).

of the success of the project entity in the same manner that capital contributions would be. If, on the other hand, the mortgage financing has priority over the claims of other creditors, or the developer has assumed liability for at least a portion of the mortgage financing, the fact that the mortgage financing would probably have the characteristics of debt under the standards described above should preclude a conclusion that the mortgage financing should be characterized as equity capital for tax purposes.

Where the project entity is a joint venture and the lender not only owns its interest in the joint venture directly but also provides the construction financing for the project, the position that the construction financing constitutes equity financing appears to have some support in the provisions of the TUPA, because those provisions would subordinate the lender's claims with respect to the construction financing to the claims of third-party creditors.[190] If the project entity is a limited partnership, however, there may be less support for this position. The TULPA places the lender's claims on at least a parity with those of third-party creditors of the limited partnership and, possibly, affords the claims of the lender for repayment of the construction financing priority over general creditors.[191]

When the developer is liable for construction financing obtained from an unrelated third party, the developer should have a basis in its interest in the project entity sufficient to deduct its share of the tax losses generated during the construction period.[192] A question arises where the construction financing is provided by the participating lender and the interest in the project entity is held by a subsidiary of the participating lender. In that event, a strong argument can be made that the lender's claims based on the construction financing should not be placed on a parity with, or subordinated to, the claims of third-party creditors.[193] Likewise, a strong argument can be made that, if the lender does not own its interest in the project entity directly, the construction financing provided by the lender should not be treated as an equity capital contribu-

190. TEX. REV. CIV. STAT. ANN. art. 6132b, § 40 (Vernon 1970). See text accompanying notes 129-32 *supra*.

191. See text accompanying notes 92-98 *supra*.

192. I.R.C. § 752(a); Treas. Reg. § 1.752-1(e).

193. See text accompanying notes 148-49 *supra*.

Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

tion for tax purposes.

When the construction financing is obtained from a source which is unrelated to the participating lender, the developer's basis ordinarily is equal to its share of the liability for repayment of the construction loan. Accordingly, when the participating lender has no liability to the construction lender, it appears that the developer should be able to include in its basis the entire amount of the construction financing for purposes of deducting construction period losses. When the participating lender has agreed to make future capital contributions which are available for repayment of the construction loan, however, it appears that the participating lender should have a basis for tax purposes equal to its agreed future capital contributions. It is not entirely clear whether the participating lender or the developer can include this portion of the liability for the construction loan in its tax basis.[194] Nevertheless, the remaining liability for the construction financing should be sufficient for the developer to deduct its share of the construction period losses.[195]

A more troublesome situation is encountered when the participating lender is not only obligated to provide future capital contributions but is also obligated to the developer to provide replacement financing for the project. If the replacement financing is deemed to constitute an equity contribution by the participating lender for tax purposes, it seems that the developer may not have any basis with respect to the construction financing, even if the construction financing is obtained from an unrelated source. This concern is compounded if the participating lender undertakes a direct obligation to the construction lender to provide the replacement financing upon the maturity of the construction financing.[196]

194. The regulations under section 752 provide that the indebtedness can be taken into account only once and imply that, in the situation described in the text, it is the partner obligated to make the future contributions (the lender) which is entitled to include that portion of the indebtedness in its basis. Treas. Reg. § 1.752-1(e).

195. For example, assume that the construction financing for which the developer solely is liable is $5,000,000 and that the lender is obligated to make $1,000,000 in future equity contributions, which would be available for the payment of construction financing. It would appear that the developer's basis would be only $4,000,000. Any construction period losses allocated to the developer, however, should be more than covered by that amount of basis.

196. In the situation described in the text, an argument could be made that the developer is not entitled to include any portion of the construction loan in its basis, because the ultimate liability for repayment of the construction loan is borne by the lender based upon

4. *Obtaining Replacement Financing.* The parties typically agree that the participating lender has the responsibility for providing or obtaining replacement financing for the project at the maturity of the construction loan. In some instances, especially when the lender is obligated to provide replacement financing, the parties may agree in advance as to the detailed terms and conditions of the replacement financing. In other instances, the parties may agree that such financing will be obtained on terms and conditions generally available in the market for such financing at the time the construction financing matures. This latter type of agreement is most common when the lender is obligated to obtain, rather than provide, replacement financing.

A major difficulty with an agreement requiring replacement financing be provided or obtained in accordance with prevailing market conditions at the time the construction financing matures is that there may not be truly comparable financing available for purposes of ascertaining an enforceable standard. When conventional permanent mortgage loans were prevalent, such a standard might have established an acceptable degree of certainty. Currently, however, it appears that most permanent mortgage financing is being provided in the context of negotiated transactions in which the terms and conditions of the mortgage financing are affected significantly by the negotiated equity participation aspects of the transaction.[197] The wide variety of issues and agreements involved in a typical equity participation arrangement may result in there being no prevailing standard available to the parties for purposes of determining the type of replacement mortgage financing which should be provided by the lender when the construction financing matures. Therefore, when a complete advance agreement is not possible, the parties should specify the terms they are willing to agree upon for purposes of narrowing the areas of potential, fu-

its obligation to the construction lender to provide replacement financing sufficient to satisfy the construction loan.

197. *See generally* Kuklin, *Real Estate Financing And The World We (Will) Live In,* 13 REAL PROP., PROB. & TR. J. 1116 (1978); McMahan, *The Future of the Real Estate Industry: Changing Supply Patterns,* 7 REAL EST. REV. 68 (1977); McMahan, *The Future of the Real Estate Industry: New Directions and New Rules,* 7 REAL EST. REV. 91 (1977); Strum, *Today's Real Estate Financing Climate—Some of the Causes and Some of the Problems,* 13 REAL PROP., PROB. & TR. J. 757 (1978).

ture controversy and achieving some standard of comparability.[198]

Uncertainty may exist with respect to the principal amount of replacement financing as well as the terms. For example, if the parties initially do not agree on an applicable interest rate or other terms which would affect debt service on the replacement financing, they will not be able to ascertain the amount of debt service the projected operating revenues of the project will support. It is possible, therefore, that the principal amount of the replacement financing will be more or less than the amount of the construction financing if it is to bear some relationship to the projected revenues.

When the replacement financing is insufficient to retire the construction financing, a method must be provided to supply the deficit. Typically, this deficiency is supplied by loans from each of the parties in proportion to their relative ownership percentages. Such loans usually bear interest, often at a rate equivalent to that being paid on the first-lien replacement financing. The interest usually is payable only to the extent that funds are available after satisfaction of operating expenses and the debt service on the first-lien replacement financing. In many cases, the lender may agree to loan the developer its share of the deficiency financing.[199]

When the proceeds of the replacement financing exceed the amount required to satisfy the construction financing, the parties may be able to make initially tax-free capital withdrawals from the project entity. The method of distributing such excess proceeds is determined by negotiation of the parties. Possible methods of distribution include: (1) dividing the excess proceeds in accordance with the parties' ownership percentages; (2) paying the excess pro-

198. For example, if the parties agreed on the maturity and amortization period for the replacement financing, they also may agree that the applicable interest rate should be equivalent to the effective internal yield to maturity on exchange-traded corporate or government bonds with a corresponding maturity and specified rating. If the parties also have agreed that projected operating income must bear a specified ratio to the debt service on the replacement financing, the determination of the interest rate and amortization period will enable them to determine the principal amount of the financing to be provided. While other formulas could be devised, it appears that the important objective is to narrow the potential for future controversies and provide a workable standard to determine what sort of replacement financing the lender will be obligated to obtain or provide when the construction financing matures.

199. See text accompanying notes 218-19 *infra*, for additional considerations the parties may wish to take into account in connection with loans by the lender to the developer of the developer's share of such deficiency financing.

ceeds as a return of capital contributions and then in accordance with ownership percentages; or (3) giving the lender a preferential distribution of the excess proceeds until its capital contributions are recovered, and then distributing the balance first to the developer to the extent of its capital contributions, or imputed equity value, and then in accordance with ownership percentages, or simply in accordance with the parties' ownership percentages.

To the extent that the lender assumes a significant share of the liability represented by the replacement financing and is allowed to include that amount in its adjusted basis for tax purposes, it should be able to receive the excess proceeds of the replacement financing as a tax-free capital withdrawal.[200] This result should be applicable even if the amount distributed exceeds the adjusted or actual capital contributions of the lender.[201] When the lender is not liable for replacement financing provided by an unrelated third-party, care should be taken to insure that the replacement financing is non-recourse as to the developer as well.[202]

The developer may have significant tax difficulties with the replacement financing whether it is equal to, or more than, the amount of the construction financing. When the replacement financing is provided directly by the participating lender and is deemed to constitute an equity capital contribution, the developer may realize taxable income upon satisfaction of the construction loan.[203] The amount of income which may be realized at that time

200. Distributions from the venture to the lender (or any venturer), in the situation described in the text should not be taxable to the extent that the distributions did not exceed the lender's basis in the venture. Such distributions do, however, reduce the lender's basis in the venture and may, therefore, ultimately increase the amount of taxable income to the lender. Thus, while the withdrawal may be tax-free initially, it is generally only a deferral, assuming that the venture ultimately is profitable. *See generally* I.R.C. §§ 705, 731(a), 733; 2 W. McKEE, W. NELSON & R. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶¶ 19.01-.04 (1977).

201. The lender's adjusted basis (i.e., original contributions, less construction period losses, if any, allocated to the lender) would be increased as a result of its share of the liability. *See* I.R.C. § 752; Treas. Reg. § 1.752-1(e). Since its basis would be in excess of its capital contribution, the withdrawal could exceed the contribution without resulting in immediate taxation.

202. Otherwise, the lender will not be able to take into account any of the loan for purposes of determining its basis. *See* Treas. Reg. § 1.752-1(e).

203. The satisfaction of the loan is a reduction in the developer's proportionate share of the liability, resulting in a deemed distribution to the developer. *See* I.R.C. § 752(b). The deemed distribution reduces the venturer's basis (not below zero), with any amounts deemed distributed in excess of its basis being taxable gain under section 731(a). I.R.C.

would consist of the entire amount of the developer's tax losses and capital withdrawals during the construction period,[204] calculated as follows. Assume that the portion of the construction financing for which the developer is liable is $5,000,000 and the developer's deductible losses and capital withdrawals during the construction period are $500,000. At the time the construction loan is satisfied, therefore, the developer has a basis of $4,500,000 in its interest in the project entity. If the replacement financing provided by the participating lender is treated as equity capital for tax purposes, the developer is relieved of $5,000,000 in liabilities, resulting in a deemed distribution to the developer of $5,000,000. Since the deemed distribution exceeds the developer's adjusted basis by $500,000, the developer has realized income in this amount. By way of contrast, if the replacement financing of $5,000,000 were obtained from an unrelated source, and the developer were allowed to include one-half of that liability in its basis, it would not realize income. The reduction in the developer's share of the liabilities of the project entity would then be only $2,500,000, well below the developer's basis of $4,500,000. In addition, the developer would have a remaining basis of $2,000,000 in its interest in the project entity.

This analysis is also applicable to the developer's share of the excess proceeds of the replacement financing. If the replacement financing provided by the participating lender is held to constitute an equity capital contribution, the refinancing proceeds distributed to the developer constitute taxable income.[205] If the replacement financing is treated as a loan for tax purposes, the developer may receive such excess proceeds as a tax-free withdrawal of capital.[206]

5. *Initial Compensation to Developer.* In instances where the lender has agreed to contribute equity capital in excess of the amount required to develop and construct the project, the excess

§§ 731(a), 752(b).

204. Both tax losses and capital withdrawals would have resulted in reductions in the developer's basis. *See* I.R.C. §§ 705, 733.

205. The statement in the text assumes that the developer has not made any capital contributions. In that event, the developer would not have any basis in its interest in the project entity and the withdrawals automatically would constitute distributions in excess of the developer's basis.

206. The developer would include its proportionate share of the loan in its basis and would be able to withdraw the excess proceeds since the withdrawal presumably would not be in excess of its basis. See note 201 *supra*.

St. Mary's Law Journal, Vol. 12 [1980], No. 4, Art. 4

funds are usually intended by the parties as compensation to the developer for its services in connection with the project's development and construction. Some method is required to enable the developer to receive such funds in the form of fees and other payments or capital withdrawals.[207] A developer usually prefers to receive its initial compensation in the form of tax-free capital withdrawals of the available mortgage and equity financing which exceeds the actual cost of development and construction of the project. The lender may agree to this procedure, especially when the lender does not participate in the tax losses generated by the project and the parties have agreed to specially allocate gain on sale of the project to the developer in the amount of the developer's capital withdrawals. When the lender participates in the tax losses generated by the project, however, ordinarily it prefers that the developer's initial compensation be paid in the form of fees rather than capital withdrawals, regardless of whether the fees are deductible immediately or must be capitalized.[208]

When the developer's initial compensation is received in the form of capital withdrawals, such amount does not generate immediate tax deductions and is not added to the project entity's tax basis for purposes of being reflected in future depreciation deductions.[209] If the developer's initial compensation is received in the form of fees, however, the lender receives the benefit of depreciation or amortization deductions with respect to those fees, even if

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207. Unlike the typical tax-shelter real estate syndication, the typical equity participation arrangement generally does not involve the payment of various fees to the developer which are structured in an effort to obtain maximum tax losses in the early years of the project. Generally, however, the developer will receive some amounts at the outset and the parties will, or could be, in conflicting positions regarding the structure of the payments. For example, the developer will generally not want to increase its income subject to immediate taxation by the receipt of fees; however, the lender will want to obtain a deduction or at least an increase in basis in the project for any payments made to the developer. The lender would not be able to achieve its objective if the amounts were treated as capital withdrawals by the parties.

208. See note 207 *supra*. Fees or other amounts paid prior to the time the project is placed in service may not be deductible since the partnership (formed to own the project) was not engaged in a trade or business until rentals were received. *See Goodwin v. Commissioner*, No. 12561-71 (T.C. Dec. 29, 1980). *But see* Blitzer v. United States, No. 426-76, (Ct. Cl. Mar. 12, 1981).

209. Since a capital withdrawal is, by definition, not a payment made to a partner other than in its capacity as a partner, it cannot be characterized as a payment for services of either a capital or non-capital nature. *See* I.R.C. §§ 707(a), 731(a).

Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

the fees are paid for construction or other services not qualifying for immediate deductibility.[210] Accordingly, a lender which participates in the tax deductions generated by the project is usually reluctant to allow the developer to receive its initial compensation in the form of capital withdrawals, insisting that such compensation be structured in the form of fees.

Where the construction financing is obtained from an unrelated third-party lender and only equity financing is provided by the participating lender, the developer should be able to make tax-free capital withdrawals from the project entity during the construction period. Care should be taken, however, to assure that the developer's share of the actual, outstanding liability for the construction financing exceeds the amount of the capital withdrawals, thus preventing the withdrawals from exceeding the amount of the developer's basis and the occurrence of an immediate taxable event.

When the participating lender provides both equity financing and construction financing, the developer may not be able to make any tax-free capital withdrawals. If the construction financing is considered to be an equity contribution by the participating lender, the developer may not include any of the liability represented by the construction financing in its tax basis. Therefore, any capital withdrawals by the developer would exceed its basis and immediately be taxable.[211]

Where the construction financing is obtained from an unrelated source and the replacement financing is provided by the participating lender at the maturity of the construction loan, the developer may realize taxable income at that time in an amount equal to its capital withdrawals. Capital withdrawals reduce or eliminate the developer's tax basis attributable to its share of the liability represented by the construction financing. Therefore, when the construction financing is satisfied with the proceeds of the replacement financing, the developer realizes income as a result of a deemed distribution, unless the developer's adjusted basis after the

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210. Such amounts presumably would be amortized over the period of time which the developer's obligation giving rise to the fee is performable, or, if the fee is paid for general services (e.g., a "development fee"), it presumably would be added to the project entity's basis in the project and depreciated over the life of the project. Some of such fees may be amortized over a 60 month period pursuant to section 102 of the Miscellaneous Revenue Act of 1980. Pub. L. No. 96-605, 94 Stat. 3521 (1980).

211. *See* I.R.C. § 731(a).

construction period losses and capital withdrawals are deducted is more than the amount by which the developer's share of the construction financing exceeds its share of the replacement refinancing.[212] Where, however, the replacement financing is provided by the participating lender and is considered to be equity financing for tax purposes, the developer would be unable to include any share of the liability for the replacement financing in its tax basis. In that event, the developer would be deemed to have been relieved of liabilities equal to the construction financing, resulting in a deemed distribution to the developer of the amount by which the construction financing exceeded its basis at the end of the construction period.

6. *Handling Cost Overruns*. The developer is usually obligated to provide funds necessary to cover cost overruns incurred during the construction period. Such cost overruns consist of either direct construction costs or costs such as construction period interest and taxes.

In many instances, the developer or its affiliate acts as the construction contractor with respect to the project, and enters into a construction contract with the project entity. Such construction contract can provide for the payment of either a "cost plus" amount or a "fixed fee" construction price.

If a "cost plus" construction contract is used, the developer ordinarily will be obligated to make capital contributions to the project entity to the extent required to make payments to the construction contractor in excess of the amount originally estimated by the parties in determining the initial funding needed for the project. This procedure allows the project entity to include the full amount paid for construction of the project in its basis for purposes of calculating depreciation. The parties, therefore, should consider whether the developer is to receive a greater share of the tax losses generated by the additional depreciation attributable to such additional contributions or simply the amount calculated pursuant to the standard agreed method of allocating losses, notwithstanding the developer's additional contributions.

If the construction contract is a "fixed fee" type contract, the construction contractor may realize a profit or loss on the contract. To the extent a profit is realized, the contractor must recognize

212. *See id.*

ordinary income. Where the construction contractor realizes a loss, a question is raised as to whether the contractor is entitled to deduct it as an ordinary loss, or if such amount should be treated as an additional capital contribution by the developer and added to its basis for tax purposes.[213] Although there is some authority to the contrary,[214] it is believed that the loss should not be treated as a capital contribution by the developer. Since the parties could have agreed on a "cost plus" contract, under which that result would be appropriate, but decided against it through their negotiations, the agreement of the parties to use a fixed fee contract has a valid business purpose and should be recognized.

Other construction period costs such as interest and taxes are usually funded by capital contributions by the developer to the extent that they exceed the amounts originally projected. Again, the developer should obtain an agreement from the lender to specially allocate these excess costs to the developer for tax purposes. As a special allocation of these costs is easily identifiable and presents fewer administrative burdens than a special allocation of additional depreciation deductions, the lender may be more willing to agree to such an allocation than it would be with respect to additional depreciation deductions.

7. *Distribution of Operating Net Cash Flow.* Determining the manner of distributing the operating net cash flow of the project is primarily a matter of business negotiation. While a variety of methods for making such distributions are used, most of such methods do not appear to present any particular tax or legal problems.

In some situations the lender requires a return on its equity in-

213. It would appear that in instances where the developer attempts to make tax-free capital withdrawals from the project entity, the construction contract will be scrutinized carefully to determine if it was set at a realistic amount or at an amount which would increase the opportunity of the developer to make such withdrawals. Assuming that the contract was set at a reasonable amount, however, and that the ultimate loss arose because of unforeseen circumstances, the question arises as to whether the loss should be treated as an ordinary business loss by the contractor or a capital contribution by the developer. In the latter event, the amount would be added to the developer's tax basis. *See* Edward T. Dicker, 22 T.C.M. 345 (1963).

214. *Id.* While the court held against the Service on a similar issue, the opinion can be read to suggest that, in the event the factual circumstances involved in the case indicate other than an arm's length transaction, it may be a closer question. *Id.* at 351-54. The case has been cited by a revenue agent in a recent audit in which the authors have been involved in support of the capital contribution theory.

vested in the project in a specified amount either indefinitely or for a specified period of time regardless of the actual net cash flow of the project. Such an arrangement may present some problems. For example, there is a question as to whether such an arrangement might result in the receipt of immediately taxable guaranteed payments by the lender.[215] To the extent such distributions to the lender represent capital withdrawals of funds contributed by lender it is unlikely that the excess distributions would be treated as taxable guaranteed payments. This rationale seems to extend not only to withdrawals of unused capital contributions made by the lender but also to unneeded portions of construction and replacement mortgage financing.[216] The same reasoning also may apply to capital withdrawals made by the lender from funds which the developer recontributed to the project entity to the extent such amounts represented capital withdrawals originally made by the developer. There seems to be some doubt, however, as to whether funds distributed to the lender in excess of the foregoing amounts may be treated as capital withdrawals when the developer had to contribute money to the project entity in order to make such funds available. Even greater doubt exists when the so-called "capital withdrawals" made by the lender exceed the equity capital it originally contributed to the project entity.[217] In the event the lender receives distributions which might be held to constitute guaranteed payments, it also should require that losses or deductions equivalent to the amount of guaranteed payments be specially allocated within the project entity to the lender in order to offset the income attributable to the guaranteed payments.

8. *Responsibility for Operating Deficits.* In many instances, the

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215. *See* I.R.C. § 707(c). To the extent made without regard to income, payments to a partner for the use of capital are considered made to one who is not a partner, for among other things, purposes of inclusion in the income of the recipient. *See* Treas. Reg. § 1.707-1(c). *See also* 1 W. McKee, W. Nelson & R. Whitmire, Taxation of Partnerships and Partners ¶ 13.03[2][b] (1977). It is important that the distribution reduce the recipients' capital account if the payment is to be treated as a return of, rather than a return on, capital. *See* I.R.C. §§ 707(c), 731(a).

216. *See* I.R.C. §§ 707(c), 731(a).

217. Where the lender receives distributions which are funded with contributions by the developer in excess of amounts, if any, previously withdrawn by the developer, and the lender previously has received distributions which equal or exceed the lender's original contributions, an argument can be made that the lender is receiving a guaranteed payment for the use of the capital it originally contributed rather than a return of its capital. *See id.* § 707(c).

developer agrees to provide the project entity with sufficient funds to defray operating deficits realized in connection with the project, either indefinitely or for a specified period of time. The parties may agree that the developer can recover the amounts advanced from the future net cash flow of the project or the proceeds of sale or refinancing of the project. On the other hand, the developer may not be entitled to any form of recoupment. After a specified period of time, the parties usually become jointly obligated to provide the necessary funds to defray operating deficits in proportion to their respective ownership percentages. Such funds may or may not be subject to recoupment. The developer should request that the lender agree to a special allocation of tax losses to the developer to the extent it is required to make disproportionate contributions, as opposed to loans, to the project entity to defray operating deficits.

The parties should also consider the proper procedure to follow when one of the parties is unable to provide its share of the funds required to defray operating deficits. The developer is usually the party concerned with this problem, as it is more likely to experience difficulties in meeting its obligations. Assuming that the lender is willing to agree to loan the required funds to the developer on an interest-bearing basis, factors which should be addressed are: (1) the method of repaying the loan; and (2) the extent to which the developer should be penalized for failing to meet its obligations.

When the lender agrees to make a loan to the developer of its share of operating deficits, the lender may insist on receiving all distributions which the developer would otherwise be entitled to receive until the lender has received the full amount of the principal and interest owed by the developer. When such an agreement is reached, it should also provide that the distributions received by the lender as payment of the developer's indebtedness be treated as distributions to the developer by the project entity for tax and accounting purposes.[218]

In some instances, the lender may insist on an incentive provi-

218. If the distributions were not so treated, the lender could receive income for tax purposes on the amount of distributions which are being paid as a result of the indebtedness, which would not appear warranted. It would seem that the better result would be to have the developer bear the consequences of the distributions for tax and accounting purposes (at least with respect to its interest in the partnership).

St. Mary's Law Journal, Vol. 12 [1980], No. 4, Art. 4

sion in the agreement in order to discourage the developer from taking advantage of the right to borrow its share of funds required to defray operating deficits from the lender. For example, the lender may require that it be entitled to receive the distributions which the developer would otherwise be entitled to receive until the lender has received not only the principal and interest on the loan but also an additional amount typically specified in terms of a percentage of the loan amount. Such an agreement, however, appears to raise a usury problem, at least to the extent that the extra amount plus the stated interest payable on the loan exceeds the maximum rate of interest allowed by law.[219] This problem might be avoided by providing for a temporary reallocation of profits within the project entity and designating the extra amount as a distribution to the lender rather than the developer for tax and accounting purposes.

9. *Allocation of Operating Income and Losses.* When the net cash flow of the project is to be distributed to the parties in accordance with their relative ownership percentages, an allocation of the net taxable income of the project to the parties in accordance with their relative ownership percentages should not present any problems. If, however, the lender is to receive a preferential distribution of the net cash flow, the developer will want the net taxable income to be distributed in proportion to the distributions of net cash flow to the extent of the total net cash flow, with only the remaining amount of taxable income, if any, being allocated to the parties in accordance with their relative ownership percentages.[220] This procedure avoids the possibility of the developer's having to pay tax on a portion of the taxable income with respect to a period when the lender received all or substantially all of the net cash flow of the project as a result of its preferential distributions.

To be effective for tax purposes, a special allocation of the net operating tax losses must have substantial economic effect.[221] As an example, it seems that a special allocation of operating losses to the developer to the extent it provided funds to defray operating

219. See text accompanying notes 21-25 *supra*.

220. Where there previously has been a special allocation of losses to one of the parties, consideration might be given to a special allocation of income in excess of net cash flow to that party until the capital accounts of the parties have been restored to a position proportionate to their relative ownership percentages.

221. I.R.C. § 704(b)(2).

Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

deficits of the project would have substantial economic effect, since such funds were expended by the project entity and gave rise to this portion of its operating tax losses. Correspondingly, substantial economic effect should exist with respect to a special allocation of operating tax losses to a lender which provided all, or substantially all, of the equity capital contributions, at least to the extent of its equity capital contributions. Beyond such amount, it seems that substantial economic effect is present only if the special allocation of losses can affect the manner in which the proceeds of the sale of the project would be distributed.[222]

One potentially troublesome problem arising in connection with the allocation of operating losses relates to accelerated depreciation and the recapture of excess depreciation on the sale or other disposition of the project. Unless specific provision is made in the equity participation agreement, there may be a question as to what portion of the gain allocated to one of the parties upon the sale of the project is to be treated as ordinary income attributable to recapture of excess depreciation and what portion is to be treated as long-term capital gain.[223] Accordingly, the agreement should provide how such excess depreciation is deemed to have been allocated between the parties initially and that amount should be the first to be allocated to the parties upon the sale of the project. One method of accomplishing this result is to provide that the excess depreciation for each year is to be deemed to have been allocated to the parties in the same proportion that they shared the income or loss of the project entity for such year.

10. *Distribution of Sale Proceeds.* A variety of agreements are reached by developers and lenders as to the methods in which the proceeds of the sale of the project are to be distributed. Often, however, these agreements fail to consider adequately other aspects of the equity participation agreement.

In a typical situation, the lender insists that the proceeds of the

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222. *See generally* 1 W. McKee, W. Nelson & R. Whitmire, Taxation of Partnerships and Partners ¶ 10.02 (1977 & Supp. 1981).

223. The recapture problem discussed here is only with respect to depreciation on section 1250 property which exceeds an amount which would have been allocated under the straight line method; that is the difference between straight line and the method of accelerated depreciation used by the partnership. I.R.C. § 1250(b). "Excess depreciation," as used in the text, refers to the difference between depreciation taken under the straight line method and an accelerated method.

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St. Mary's Law Journal, Vol. 12 [1980], No. 4, Art. 4

sale of the project be distributed first to the lender until it has recovered its capital contributions to the project entity. The lender may agree that its capital contributions can be reduced for this purpose by the proceeds of refinancing or other interim capital transactions previously received by the lender. In rare instances, a lender also may agree that its capital contributions can be reduced for this purpose by net cash flow distributions previously received in excess of its agreed preferential amount of net cash flow distributions. After the lender has received its unrecovered capital contributions, the balance of the proceeds of the sale may be distributed first to the developer until it has received a subordinated preferential amount and then in accordance with ownership percentages, or may simply be distributed in accordance with the parties' relative ownership percentages.

The difficulty with this traditional method of distributing sale proceeds is that it does not take into account the status of the parties' capital accounts at the time of the sale. As a result, such method may fail to provide substantial economic effect for any agreed special allocations of losses,[224] as well as produce an inequitable result. Described below is a method of distributing the proceeds of the sale which it is believed will avoid both of these problems without unduly hindering the achievement of the parties' objectives.

Immediately prior to the sale of the project, the capital accounts of the parties reflect an updated history of the operations of the project entity, including contributions, distributions, losses, and income. Accordingly, if a party has a positive capital account, that party has made capital contributions or received allocations of income which have exceeded its distributions and allocations of losses. Conversely, if a party has a negative capital account, that party has received distributions or allocations of losses which have exceeded its contributions and allocations of income. It seems only equitable that the proceeds of the sale be used first to place the parties in a position commensurate with their relative ownership percentages in the project entity. In addition, this same procedure seems to be necessary in order for any special allocation of losses to have the requisite substantial economic effect.

224. *See generally* 1 W. McKee, W. Nelson & R. Whitmire, Taxation of Partnerships and Partners ¶ 10.02 (1977 & Supp. 1981).

Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

For example, assume that the lender originally contributed $2,000,000 and the developer originally contributed $2,000,000, that the developer has a positive capital account at the time of the sale of $500,000, that the lender has a negative capital account at the time of the sale of $1,500,000 resulting from tax losses and cash flow distributions, that the lender and the developer each own a 50% interest in the project entity, that the net proceeds of the sale are $6,000,000, and that the gain realized on the sale is $7,000,000. If the lender receives the first $2,000,000, the developer receives the next $2,000,000, and they equally divide the remaining $2,000,000, the lender would have a negative capital account of $4,500,000 and the developer would have a negative capital account of $2,500,000 after the proceeds are distributed and before the gain is allocated. Presumably, the $7,000,000 gain realized on the sale would be allocated $2,500,000 to the developer and $4,500,000 to the lender, so that the capital accounts would be brought to zero. The developer would have received $3,000,000 in proceeds and $2,500,000 in gain, and the lender would have received $3,000,000 in proceeds and $4,500,000 in gain. While the developer does not recognize gain on the $500,000 of previously taxed income it had in its capital account in the project entity immediately prior to the sale, the lender does recognize additional gain with respect to its $1,500,000 negative capital account resulting from tax-free distributions or allocations of losses previously received by the lender. It appears, however, that such method of distribution is neither equitable nor results in substantial economic effect sufficient to support the allocation of losses previously made to the lender.

A better method of distribution would be the following. First, the developer would receive $500,000 to eliminate its positive capital account and $1,500,000 to equalize the capital accounts of the parties. The lender would receive the next $2,000,000. The remaining $2,000,000 would be divided equally between the parties.[225]

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225. It should be noted that the manner of distributing the $4,000,000 remaining after the capital accounts have been equalized is not critical. That amount could, for example, be distributed equally between the parties. As noted in the following portions of the text the use of proceeds to the extent necessary to equalize the capital accounts is the critical aspect of the distribution formula. The example simply illustrates the typical situation where the lender wishes to recover its unrecovered capital contributions before the developer recovers its contributions or makes any profits on the transaction.

The developer would then have a negative capital account of $2,500,000 and the lender would have a negative capital account of $4,500,000. The $7,000,000 gain could be allocated to the parties in these amounts in order to restore their capital accounts to zero. The developer would have received $3,000,000 in proceeds and $2,500,000 in gain and the lender would have received $3,000,000 in proceeds and $4,500,000 in gain.

In the foregoing example both methods produce exactly the same ultimate distributions of proceeds and allocation of gain. While this is usually the result when the proceeds of the sale equal or exceed the original contributions of the parties, the true test of substantial economic effect is the result when the proceeds of the sale do not equal or exceed the original contributions of the parties.[226] Accordingly, assume the facts of the foregoing example, except that the proceeds of the sale are only $2,000,000 and the gain is only $3,000,000. Under the first method of distribution, the lender would receive the entire $2,000,000 proceeds and the developer would receive none, resulting in a negative capital account of $3,500,000 for the lender and a positive capital account of $500,000 for the developer. If the $3,000,000 gain is all allocated to the lender, the parties are left in the awkward position of having a negative capital account of $500,000 for the lender and a positive capital account of $500,000 for the developer. If the agreement for the project entity provides that the parties are not responsible for restoring negative capital accounts, the developer will have sustained a $500,000 loss on the transaction. Moreover, in such a situation, it is likely that the Service will challenge the allocation of losses to the lender as not having substantial economic effect.[227]

The second distribution method would produce a more equitable and defensible result. The entire $2,000,000 in sale proceeds would be distributed to the developer, first to eliminate its $500,000 positive capital account and then to equalize its negative capital account with the lender's $1,500,000 negative capital account. The $3,000,000 gain would then simply be allocated equally to the

226. Orrisch v. Commissioner, 55 T.C. 395, 403 (1970), *aff'd*, 31 A.F.T.R.2d 73-1069 (9th Cir. 1973).

227. *See generally* 1 W. McKee, W. Nelson & R. Whitmire, Taxation of Partnerships and Partners ¶ 10.02[2][b] (1977). *See also* Private Letter Rul. 80-08054 (National Office Technical Advice Memorandum, Nov. 28, 1979).

Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

parties.

11. *Allocation of Gain and Loss on Sale.* One method for allocating gain arising from the sale of the project is in accordance with the sale proceeds to the extent thereof, and then in accordance with negative capital accounts. If the sale proceeds have been distributed in a manner which produces negative capital accounts for the parties which are proportionate to the parties relative ownership percentages in the project entity, this procedure will result in the allocation of the non-cash gain in accordance with those relative ownership percentages. If the proceeds are not sufficient to produce negative capital accounts which are proportionate to the parties' relative ownership percentages, the allocation of the non-cash gain in accordance with negative capital accounts will still produce an appropriate result, since the disproportionately larger amount of non-cash gain allocated to one or the other of the parties will reflect additional loss allocations or tax-free distributions received by that party which were disproportionately larger than its relative ownership percentage. In general, therefore, this method of allocating gain on the sale of the project will produce a fair and logical result.

The parties also should consider special allocations of gain to reflect certain events which may have occurred prior to the sale of the project. Examples of this type of event include: (1) where the project is under construction at the time it is conveyed to the project entity and the liability on the construction loan exceeds the developer's basis for tax purposes in the project at that time, due to construction period losses claimed by the developer which were funded with the proceeds of the construction loan or withdrawals by the developer of proceeds of the construction loan in excess of the amounts spent for capital costs; (2) where one of the parties received a tax-free distribution of the net proceeds of a refinancing which is disproportionate to its relative ownership percentage; and (3) where one of the parties has received special allocations of tax losses in excess of its capital contributions resulting in a disproportionately large negative capital account. In each of these situations, the parties may believe that it is only fair that the first gain realized from the sale of the project be allocated to the party which received the benefit of the prior event.

This type of special allocation of gain on sale probably will be acceptable to the parties to the extent that the gain attributable to

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the amount by which the mortgage financing on the project at the time of sale exceeds the tax basis in the project at that time is considered to be realized in the year of sale.[228] In that event, the gain realized in the year of sale will include both the amount by which the mortgage exceeds the project's basis and the amount of any cash sale proceeds received in the year of sale. Consequently, the special allocation of the gain attributable to the mortgage in excess of basis to the party benefiting from the events which resulted in the mortgage being in excess of the basis and the allocation of any additional gain in accordance with the distribution of the cash proceeds received in the year of sale should produce the correct result.

It can make a significant difference to the parties whether the proceeds of the sale are distributed before or after the gain is allocated. Since many equity participation arrangements will involve some type of special allocation of losses, it is believed that a method which distributes the proceeds of the sale before the gain is allocated will be more likely to provide the necessary substantial economic effect required to support such special allocations.[229] In any event, the agreement between the parties should specify clearly the order in which the distribution of proceeds and the allocation of gain should be accomplished.

C. *Analysis of Convertible Mortgage Arrangement*

A convertible mortgage arrangement is one in which the participating lender does not own an interest in the project at the outset

228. When taxpayers attempted in the past to defer gain attributable to the extent their mortgage exceeded their basis in real property by use of a wrap-around mortgage sale transaction, it was possible that gains realized in the year of sale would reflect only a portion of the amount by which the mortgage exceeded the basis in the project. In that event, the party benefiting from the transactions which gave rise to the mortgage in excess of basis should have obtained an agreement that the corresponding gain would not be allocated to that party until that portion of the gain was actually reported with respect to the sale. Such an agreement was seldom made, however, which resulted in many situations where one party received cash proceeds of the sale in the year of sale in excess of the gain allocated to it and the other party received a substantial gain allocation and little or no cash in the year of sale. In view of the fact that it now appears difficult, if not impossible, to obtain such a deferral by using a wrap-around mortgage transaction, this anamoly probably will not be encountered in the future. *See* Temp. Treas. Regs. § 15A.453-1(b)(3)(ii), T.D. 7768 (Jan. 30, 1981).

229. See text accompanying notes 224-26 *supra.*

but has a right to convert all or a part of its mortgage into an ownership interest in the project in the future.

1. *Operations Prior to Conversion.* With one possible exception, it appears that the operations of the project during the period prior to the lender's conversion of its mortgage are substantially the same as when the developer owns the project and the lender is simply providing the mortgage financing for the project without having an option to convert all or part of its mortgage financing into an ownership interest in the project. The developer should be able to take advantage of the benefits generated by the project during the early years of its existence without being subject to the kinds of limitations and restrictions which might be applicable in an initial ownership arrangement.

The one possible exception to the foregoing pattern is when the mortgage financing provided by the lender is nonrecourse financing secured only by the project, and the lender has only an option to convert all of the mortgage financing into an interest in the project. In that event, Revenue Ruling 72-350[230] indicates that the Service might not allow the mortgage financing provided by the lender to be included in the developer's tax basis in the project. As a result, the extent to which the developer could deduct depreciation on the project and receive tax-free net cash flow from the project would be limited to the amount of capital which the developer provided for the project in excess of the mortgage financing.

In some cases, the lender may not be willing to convert the entire amount of the mortgage financing into an ownership interest in the project. In such instances, it appears that the reduction in basis which the developer may suffer due to the implications of Revenue Ruling 72-350[231] would be limited to the portion of the mortgage financing which the lender is willing to convert. The developer should still, however, be able to claim reduced amounts of depreciation and receive reduced amounts of tax-free net cash flow from the project proportionate to the amount of the mortgage financing which is not converted.

There may be some logic for treating the mortgage financing provided by the lender as an equity capital contribution in the context of an initial ownership arrangement, particularly if the

230. 1972-2 C.B. 394.
231. *Id.*

project entity is a joint venture. It does not appear, however, that there is any logic to the implication of Revenue Ruling 72-350 that mortgage financing provided by the lender in a convertible mortgage arrangement should be treated as an equity capital contribution.[232] Neither the TULPA nor the TUPA appear to impose any restrictions on the priority of the mortgage financing provided by the participating lender in a convertible mortgage arrangement prior to the time the mortgage financing is converted.[233] In addition, it is unlikely that the Service would allow the participating lender to claim depreciation and other deductions generated by the project during the period prior to the conversion.[234] If the transaction is viewed from the perspective of the developer, so that Revenue Ruling 72-350 is interpreted as simply not allowing the developer to include the convertible mortgage financing in its basis in the project because the participating lender and not the developer bears the risk of loss with respect to the mortgage financing, no logical reason is perceived why that rule should apply just because the lender has a right of conversion when it would not apply if the lender made the same nonrecourse loan without an accompanying right of conversion.[235] For the foregoing reasons, although developers should be aware of the potential problems of Revenue Ruling 72-350 in connection with a convertible mortgage arrangement, it is believed that a persuasive argument can be made that the devel-

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232. Until the conversion is made, which is solely in the control of the lender, the mortgage financing is not at the risk of the project in the same manner as it would be as an equity contribution.

233. Prior to the conversion, the lender would not be a partner and the terms of the TULPA and TUPA with respect to priority of claims or judgments presumably would not apply. *See* TEX. REV. CIV. STAT. ANN. art. 6132a, §§ 14, 24, & art. 6132b, § 40 (Vernon 1970). This assumes, of course, that the relationship between the parties prior to the conversion would not be structured in a manner which could be deemed to constitute a partnership for the purposes of either act.

234. The argument of the Service, in this regard, normally would be that the economic benefits and burdens of ownership did not fall on the lender, and that it did not use or hold the property in a trade or business. Of course, it is unlikely that the lender would have claimed any depreciation or other deductions in connection with the project prior to the time it converted. If the Service disallows the developer's deductions during the pre-conversion period and the lender amends its returns for open years, claiming deductions for that period, the Service would likely take inconsistent positions with respect to the lender and the developer.

235. *See generally* 1 W. MCKEE, W. NELSON & R. WHITMIRE, TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 7.01[3] (1977) (discussing Crane v. Commissioner, 331 U.S. 1, 14 (1947)).

Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

oper should not be precluded from including the mortgage financing in its basis prior to conversion.

2. *Tax Effects of Conversion.* If the mortgage financing is nonrecourse financing which is all subject to conversion and the developer is not allowed to include any of the mortgage financing in its basis in the project prior to conversion, it appears that the conversion of the mortgage financing into an ownership interest in the project would not have any tax effect on the developer. The developer would not have been allowed previously to take advantage of any tax benefits which were related to the convertible mortgage financing. It is difficult to determine, therefore, that the mortgage financing properly would be treated as part of the proceeds of the sale realized by the developer upon the conversion of the mortgage financing. It certainly seems inequitable to treat the convertible mortgage financing as equity capital prior to the conversion and then to treat it as true mortgage financing upon the conversion for purposes of calculating gain realized by the developer as a result of the conversion.

It may be, on the other hand, that all of the mortgage financing is subject to conversion, but that fact did not preclude the developer from including the mortgage financing in its tax basis in the project, either because Revenue Ruling 72-350 is determined to be incorrect or inapplicable or because the developer was liable for the mortgage financing.[236] In that event, the conversion of all or a portion of the mortgage financing by means of a conveyance of an interest in the project by the developer to the lender in consideration for a reduction of all or part of the mortgage financing should produce the same tax effect for the developer as the sale of an interest in the project would produce. The portion of the mortgage converted by the lender would be deemed to be the proceeds of the sale and the basis which the developer had in the project would be allocated between the interest in the project which the developer retains and the interest in the project which the developer conveys to the lender as a result of the conversion. The gain realized by the developer would be determined in the same manner as if the lender had paid the developer cash equal to the amount of the mortgage being converted and the developer had used that cash to

236. *See* I.R.C. § 752; Treas. Reg. § 1.752-1(e).

pay all or a portion of the mortgage financing.[237] As might be suspected, this procedure may produce gain for the developer far in excess of the amount anticipated by the parties.

For example, assume that the developer obtains $5,000,000 in mortgage financing from the lender, that the financing is convertible in its entirety into a 50% ownership interest in the project, and that the developer's basis for tax purposes in the project immediately prior to the conversion is $5,000,000. As a result of the conversion, the developer will be considered to have received proceeds in the amount of $5,000,000 for the sale of a 50% interest in the project. Since the developer will be deemed to have a basis of only $2,500,000 in the 50% interest in the project which was acquired by the lender as a result of the conversion, the developer will have realized a gain of $2,500,000 as a result of the conversion. Probably few developers would anticipate such an adverse result in a situation such as this. Since the result clearly would be correct if the developer had sold a 50% interest in the project for $5,000,000 and then used the proceeds to satisfy a $5,000,000 mortgage loan on the project, there is no apparent justification for reaching a different result in connection with the convertible mortgage as illustrated in the foregoing example.

The tax consequences in the example given above would be less onerous if the lender had converted only part of its mortgage financing into an ownership interest in the project. As a practical matter, however, the developer would not be willing to give the lender an ownership interest in the project equal to the same percentage as the percentage which the portion of the mortgage financing to be converted represents of the total mortgage financing. For example, the developer is unlikely to agree to give the lender a right to convert 20% of the mortgage financing into a 20% ownership interest in the project, because such an agreement would not give any recognition to the value of the developer's equity interest in the project. Only in this manner, however, would the developer be able to avoid recognition of gain on the conver-

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237. *Cf.* Byram v. Commissioner, 555 F.2d 1234 (5th Cir. 1977) (illustrating requirement that basis be allocated). If the partnership rules were applicable, the conversion by the lender (and consequent reduction in the developer's share of liabilities) would be considered a deemed distribution to the developer and would reduce the developer's basis through operation of sections 731, 733, and 752. *See* I.R.C. §§ 731(1), 733, 752(b). To the extent the deemed distribution exceeded the developer's basis, it would be taxable. *See* I.R.C. § 731(a).

Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

sion of the mortgage as illustrated above.[238] In any situation where the lender receives an ownership interest in the project as a result of the conversion which is less than the percentage which the converted portion of the mortgage financing represents of the total mortgage financing, the developer will be required to recognize a significant amount of gain, unless all or a portion of the gain is offset by additional basis attributable to capital provided by the developer in excess of the convertible mortgage financing provided by the lender.

The amount of gain required to be recognized by the developer would be increased to the extent that the developer's basis in the project immediately prior to the conversion was less than the amount of the mortgage financing.[239] In that event, gain also would have to be recognized by the developer even if the ownership percentage interest acquired by the lender was equal to the percentage which the converted portion of the mortgage financing represented of the total mortgage financing.[240]

It appears that the adverse tax consequences of a direct conversion of the mortgage financing may be avoided or reduced, if the parties utilize a partnership to accomplish the conversion. This technique would involve the formation of a partnershp comprised of the developer and lender prior to accomplishing the conversion. The developer would contribute the project to the partnership subject to the mortgage and the lender would contribute money to the partnership in the amount of the agreed reduction in the mortgage.

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238. The portion of the developer's basis attributable to the portion of the project obtained by the lender is the same when stated as a percentage — e.g., 20% of the developer's basis is attributable to 20% of the project being obtained by the lender. The developer's basis must be apportioned or spread across its entire interest. Presumably, when considering an undivided interest in the entire project or an interest in a venture, the percentage being sold or converted would be the applicable percentage of the basis to be taken into account to determine gain. *See* Treas. Reg. § 1.61-6(a). Thus, if the developer has not made an equity investment, the maximum basis it could have would be 100% of the loan, spread over the entire project. If the percentage of the mortgage being converted is greater than the percentage of the project being obtained, the developer will have gain if it has not made sufficient capital contributions to offset that difference.

239. Construction period losses taken into account by the developer could reduce its basis below the amount of the mortgage financing.

240. In any case where the portion of the mortgage converted exceeded the developer's basis attributable to the interest acquired by the lender, the developer presumably would be required to recognize gain. *See generally* 1 W. McKee, W. Nelson & R. Whitmire, Taxation of Partnerships and Partners ¶ 4.03[2] (1977).

The partnership would then apply the money contributed by the lender to the mortgage. The developer would receive a deemed distribution at the time the project is contributed in an amount equal to a percentage of the mortgage which is the same as the lender's ownership percentage in the partnership.[241] The developer would receive an additional deemed distribution in an amount equal to a percentage of the amount by which the mortgage is reduced with the funds contributed by the lender which is the same as the developer's ownership percentage interest in the partnership.[242] If the entire mortgage is converted in this manner, therefore, the developer will receive a deemed distribution equal to the amount of the mortgage. It seems that the only gain recognized by the developer, however, would be the amount by which the mortgage financing exceeded the developer's basis at the time the project was contributed to the partnership.[243] The successful use of a partnership to accomplish the conversion of the entire mortgage results in the developer's having no basis after the conversion, but the developer will have avoided recognizing gain as a result of the conversion except to the extent of its prior tax losses and cash withdrawals from the mortgage financing.[244] If the entire mortgage is converted, the lender will have a basis equal to the amount contributed to convert the mortgage.[245]

3. *Operations After Conversion.* After the conversion of all or part of the mortgage, the ownership and operation of the project generally should be subject to the normal rules governing partners owning real property jointly, with the parties' respective bases in the project dependent upon the manner in which the conversion was accomplished. There is a possible problem in this regard, however, to the extent that the mortgage is only partially converted. In that event, it is possible that the unconverted portion of the mortgage would be deemed to constitute an equity capital contribution,

241. The deemed distribution would occur as a result of the reduction in the developer's proportionate share of the liability to which the project is subject. This deemed distribution would reduce the developer's basis to $2,500,000. *See* I.R.C. § 733.

242. *See id.* § 752(b). This deemed distribution would further reduce the developer's basis by $2,500,000, or to $0. *See id.* § 733.

243. See note 240 *supra.*

244. The prior losses and withdrawals would have reduced the developer's basis, thereby making the mortgage-in-excess of basis rules applicable. See note 240 *supra.*

245. *See* I.R.C. § 722.

resulting in a further reduction of the developer's basis, potential benefits attributed to tax losses, and tax-free distributions after the partial conversion.[246]

D. *Analysis of Purchase Option Arrangement*

A purchase option arrangement is one in which the participating lender does not own an interest in the project at the outset but has a right to acquire an ownership interest in the project for additional consideration.

1. *Operations Prior to Exercise of Option.* The operations of the project prior to the time the lender exercises its option to acquire an interest in the project should not be affected by the existence of the option. The fact that the lender has a right to become a joint owner of the project, and presumably a partner of the developer, should not cause the lender's mortgage financing to constitute equity capital for purposes of reducing the developer's basis. Accordingly, prior to the exercise of the option, the developer should be treated as the sole owner of the project for tax purposes.[247]

2. *Tax Effects of Exercising Option.* When the developer conveys an interest in the project directly to the lender upon the exercise of the purchase option, the transaction will be treated as a sale of an interest in the project. Consequently, the developer will recognize gain to the extent that the sum of the percentage of the mortgage equal to the ownership percentage conveyed to the lender plus the option price paid by the lender exceeds the developer's proportionate basis in the ownership percentage conveyed to the lender.[248] Assuming that the developer's basis in the project is

246. The developer would be able to deduct its allocable share of the venture's losses and receive initially tax-free distributions only to the extent of its basis. *See id.* §§ 704(d), 731(a)(1).

247. See note 233 *supra*. The same general considerations would apply in the determination of whether the developer or the lender was the owner of the project for tax purposes prior to exercise of the option as would apply in connection with a convertible mortgage prior to a conversion.

248. For example, assume that the mortgage is $5,000,000, the developer's basis is $5,000,000 and the lender's option is to acquire a 50% interest in the project upon payment of $1,000,000 to the developer. The conveyance by the developer of a 50% interest in the project will reduce the developer's basis by 50%, or $2,500,000, which is the amount of the developer's basis attributable to the portion of the project being conveyed. The $1,000,000 paid to the developer for the interest will be taxable in full, since its basis in the 50% being

equal to the amount of the mortgage, the developer will recognize gain only to the extent of the option price. If the developer's basis is less than the amount of the mortgage, additional gain will have to be recognized by the developer.[249]

The developer may avoid recognizing gain with respect to the amount by which the mortgage exceeds its basis by contributing the project to a partnership comprised of the developer and lender in lieu of conveying an interest in the project directly to the lender. In that event, the transaction might be treated, at least partially, as a return of basis, with the developer required to recognize gain with respect to the mortgage in excess of the basis only in the unlikely event that the reduction in the developer's share of the liability for the mortgage exceeded its basis in the project prior to the formation of the partnership.[250]

The formation of a partnership, as described above, probably will not allow the developer to avoid recognizing gain with respect to the option price paid by the lender. If the option price is contributed by the lender to the partnership and then distributed to the developer, it is likely that the Service would apply the provisions of the regulations under section 731 of the Code to recast at least that part of the transaction as a sale of an interest in the project directly to the lender.[251] In that event, the Service might

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conveyed is, at that point, $0.

249. If the developer's basis in the example set forth in note 248, *supra,* were $4,500,000 (as a result of, *e.g.,* withdrawals or construction period losses), the portion of that basis attributable to the interest conveyed would be $2,250,000, resulting in a $250,000 non-cash gain to the developer in addition to the $1,000,000 gain from the sale.

250. In the example contained in note 249 *supra,* if the developer contributed the project to a 50-50 venture, there would be a deemed distribution upon contribution of $2,500,000 (one-half of the mortgage), thereby reducing the developer's basis to $2,000,000. *See* I.R.C. §§ 752(a), 733. The lender's $1,000,000 cash contribution, if withdrawn by the developer, theoretically would be tax free under section 731 since the contribution would not exceed its basis. *See id.* § 731(a). The contribution, however, would reduce the developer's basis to $1,000,000. *See id.* § 733. *See* Otey v. Commissioner, 634 F.2d 1046 (6th Cir. 1980). In that case, the court affirmed the Tax Court's opinion holding that the contribution of property to a partnership, followed a short time later by a withdrawal of funds in an amount approximately equal to the market value of the property contributed was not a sale. The case differs from the typical lender-developer transaction, however, in that there were no other contributions to the capital at the time the withdrawal was made, and the funds withdrawn were the proceeds of a loan. *Id.* at 1047.

251. *See* Treas. Reg. § 1.731-1(c)(3). *But see* Otey v. Commissioner, 634 F.2d 1046 (6th Cir. 1980). The *Otey* case differs from the factual situation presented because of the significant capital contribution of the lender. *See generally* 1 A. WILLIS, PARTNERSHIP TAXATION

Barton and Morrison: Equity Participation Arrangements between Institutional Lenders a

also seek to recast the entire transaction, resulting in additional gain to the developer with respect to the amount by which the mortgage exceeds its basis.[252]

3. *Operations After Option is Exercised.* Unless the lender's mortgage is treated as an equity capital contribution after the purchase option is exercised, the subsequent operations of the project should be subject to the general rules regarding partners owning real property jointly, with their respective bases dependent upon the manner in which the purchase option was consummated and treated for tax purposes.

VI. Conclusion

Equity participation arrangements between institutional lenders and real estate developers increasingly are becoming common. Much of the continuing activity in the real estate industry is attributable to the ability of lenders and developers to reach agreements of this sort, thereby mitigating the adverse impact which inflation has had on traditional methods of obtaining mortgage financing for real estate projects. Equity participations, however, do present significant areas of concern for both parties. Therefore, such arrangements should be utilized with due appreciation for the tax and other legal risks involved.

14.08 (1976 & Supp. 1980).

252. See note 249 *supra*.