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Common Tax Issues in Partnership and Real Estate Transactions

Trip Dyer

Tax Law in a Day

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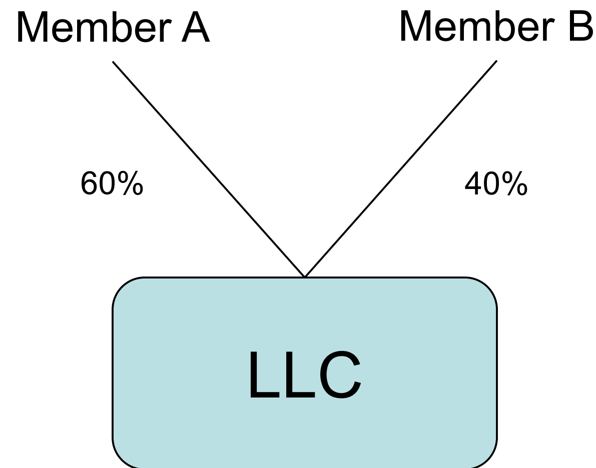
Partnership Taxation



- Partnerships are flow-through entities
  - Income, gain and loss are recognized at the entity level, but partnership does not pay tax itself
  - Income, gain and loss flow through to the partners, who take the items into account on their own tax returns
  - Generally, contributions of cash or property to a partnership do not result in tax
  - Generally, distributions of cash or property to a partner do not result in tax

Issue: Choice of Entity

"I'm putting together a new real estate venture. I want to form a corporation to take advantage of the new 21% rate."

Choice of Entity: Effective Tax Rate

C Corporation		Partnership	
Taxable Income	$ 100.00	Taxable Income	$ 100.00
Corporate Rate	21%	Partnership Rate	0%
Corporate Tax Liability	$ 21.00	Partnership Tax Liability	$ -
Net Cash to Distribute	$ 79.00	Net Cash to Distribute	$ 100.00
Individual Rate	20%	Individual Rate	37%
NII Rate	3.80%	NII Rate (if applicable)	3.80%
Individual Tax Liability	$ 18.80	Individual Tax Liability	$ 40.80
Total Tax Liability	$ 39.80	Total Tax Liability	$ 40.80

- Currently, small rate difference in favor of corporations
  - Assuming taxpayer is in highest bracket, NII tax is applicable and no partnership income deduction
- Generally, still prefer partnerships to corporations
  - Greater flexibility (e.g., issuance of profits interests, TIC like-kind exchanges)
  - Individual and corporate rates may change in the future
  - Changing from corporate form to partnership can result in a large tax bill
  - Losses flow through to partners

Deduction for Partnership Income

- 2017 Tax Act provides non-corporate partners with a deduction of up to 20% of their "qualified business income"
- Qualified business income: generally, income from a trade or business that is not a "specified service trade or business"
  - Rental real estate (other than triple net leases) may be treated as a trade or business for these purposes
  - Excludes investment items (capital gain or loss, dividends, interest), compensation, partnership guaranteed payments
  - Specified service: law, accounting, businesses where the principal asset is the reputation or skill of employees (excludes architecture and engineering)
- For taxpayers with income over certain thresholds ($415,000 married filing jointly), limited to the greater of:
  - 50% of W-2 wages paid by a trade or business, or
  - 25% of W-2 wages + 2.5% of unadjusted basis of tangible depreciable property
  - Entities may be aggregated for purposes of determining W-2 wages and basis

Choice of Entity: Considerations

- For federal income tax purposes, an LLC with multiple members is taxed as a partnership by default
- Typically, LLCs are recommended
  - Greater management flexibility than limited partnerships, which must have a general partner
  - Certain business (investment funds, oil and gas, real estate) based in Texas may benefit from being formed as a limited partnership, however
- Texas Franchise Tax
  - Generally, a .75% tax on revenues exceeding $1,180,000
  - Franchise tax does not apply to "passive entities"
    - At least 90% of gross income from passive sources
  - Limited partnerships can be passive entities
  - LLCs ***cannot*** be passive entities

Issue: Employees as Partners

"I'm bringing in a new employee as a 'partner' in my LLC."

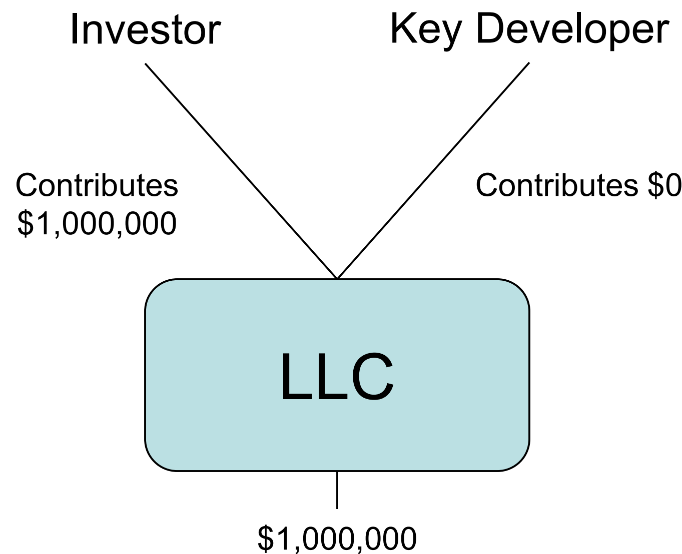
Employees as Partners

- An individual who is a partner of a partnership cannot be an employee of the partnership, for federal income tax purposes
- Generally, an employee would not want to be taxed as a partner
  - Receive Schedule K-1 (allocated income) instead of Form W-2 (wages); potential phantom income
  - Pay estimated taxes quarterly
  - May be subject to taxes in other states where partnership does business
  - Limitations on benefits (e.g., payment of group health benefits)
  - Subject to self-employment taxes (pay 100%) rather than employment taxes (pay 50%)
- It is possible to structure around this issue by having the employee own a partnership interest in or be employed by a different entity

Issue: Capital Shift

"I have a new real estate business or development that I'm creating. I'm putting in $1 million, I have a key developer that I need to hire or engage, and I'm going to give him a 10% interest in the new deal, so we're going to form an LLC. I'll put in $1 million and we'll allocate income, losses and distributions 90/10."

Capital Shift



- This results in a taxable transaction
  - Key Developer was granted property (the LLC interest) that was worth $100,000
- If the LLC liquidated on the date of formation, Key Developer would receive $100,000 and Investor would receive $900,000
- Results in $100,000 of taxable income for Key Developer as of the date of issuance of the LLC interest

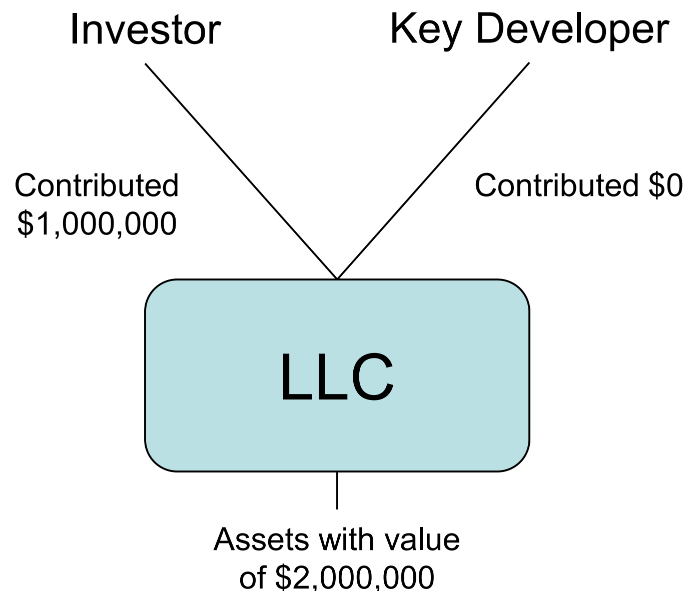
Solution: Profits Interest

- Key Developer could be granted a "profits interest"
  - Also referred to as a promote interest or carried interest
  - Profits interest, by definition, would not receive a distribution if the LLC liquidated immediately after formation
- Capital event waterfall should be drafted to ensure Key Developer is granted a profits interest
  - Example (grant of profits interest on initial formation):
    - First, to the Members pro rata in accordance with their Unreturned Capital Contributions until the Unreturned Capital Contribution of each Member has been reduced to zero, and
    - Thereafter, 90% to Investor and 10% to Key Developer
  - Because Investor would receive all of its capital contributions before the 90/10 split, key manager/developer would not receive a distribution if the LLC liquidated on the date of formation. Thus, the profits interest has a value of $0 on date of grant
- If a profits interest is granted after the initial formation, the entire value of the LLC, as of the date of grant, must be distributed upon a capital event before the profits interest receives distributions

Issue: Catch-Ups

"So, how can I get the key developer to the same place where he gets 10% of the economics of the deal without immediate taxation?"

Example: <u>**No**</u> Catch-Up Distribution

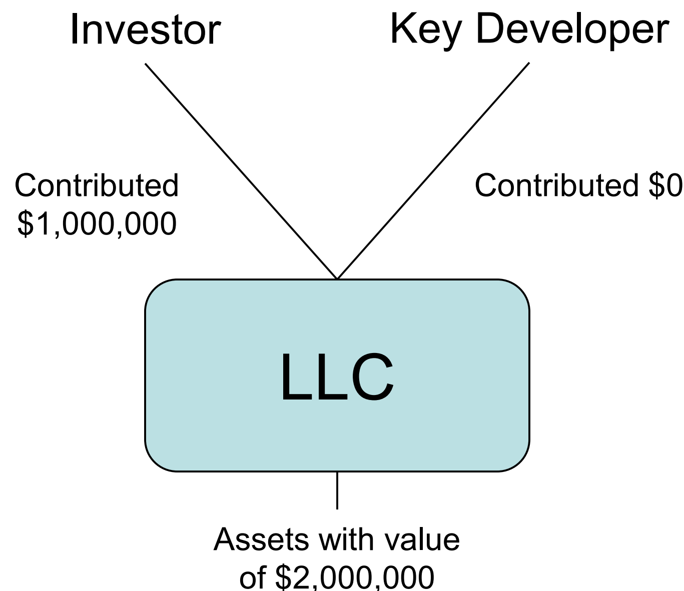


- Example: LLC sells assets and has $2,000,000 to distribute
  - First, Investor receives $1,000,000 as a return of its capital contribution
  - Next, Investor receives $900,000 (90%) and Key Developer receives $100,000 (10%)
- Investor received $1,900,000 of distributions (95%)
- Key Developer received $100,000 of distributions (5%)

Solution: Catch-Up Distribution

- To ensure that Key Developer receives 10% of all distributions, without causing a capital shift, the waterfall can include a catch-up provision
- Example:
  - (a) First, 100% to the Members pro rata in accordance with their Unreturned Capital Contributions until the Unreturned Capital Contribution of each Member has been reduced to zero;
  - (b) Next, 100% to Key Developer until such time as Key Developer has received aggregate distributions equal to 10% of all distributions made pursuant to Section (a) and this Section (b); and
  - (c) Thereafter, 90% to Investor and 10% to Key Developer
- Risk to Key Developer: that the LLC will not make enough profit to allow for full payment of catch-up distributions

Example: Catch-Up Distribution



- LLC liquidates and has $2,000,000 of sales proceeds to distribute
  - First, Investor receives $1,000,000 as a return of its capital contribution
  - Next, Key Developer receives $111,111 (catch-up)
  - Thereafter, Investor receives $800,000 (90%) and Key Developer receives $88,889 (10%)
- Investor received $1,800,000 of distributions (90%)
- Key Developer received $200,000 of distributions (10%)

New Carried Interest Legislation

- Generally, the character of income recognized by a partnership flows through to its partners
  - Example: LLC sells a capital asset held for more than 1 year, long-term capital gain flows through to its members
- 2017 Tax Act provides for special rules for certain carried interests, promote interests and profits interests
  - Capital assets must be held for more than 3 years to be treated as long-term capital gain *with respect to applicable carried interests* (but not capital interests)
  - Also, applicable carried interests must be held for more than 3 years to qualify for long-term capital gain treatment upon their sale
- Does not appear to apply to dispositions of certain real estate
  - Certain real estate is “1231 property” not a “capital asset”, even though gain from sale of 1231 property is taxable as capital gain
  - Under a strict reading of the statute, the 3 year rule does not apply
- No grandfather provision for existing partnerships
- Legislation is ambiguously drafted and many questions remain

Issue: Allocation of Gain In Lieu of Fees

"I am a developer and I am going to participate in this new partnership. I'm going to receive $500,000 in fees, but I also have to contribute $300,000 to the partnership."

Solution: Allocation of Gain In Lieu of Fees

- Developer should consider restructuring the arrangement
  - As proposed, $500,000 in fees would be taxable as ordinary income
- Instead, Developer could waive $300,000 of the fee and have it treated as a "deemed capital contribution"
  - Developer would not receive $300,000 of the fee, but would also not have to make a $300,000 contribution
- Developer *<u>might</u>* convert $300,000 of ordinary income (from fee) into $300,000 of capital gain (from sale of project)
- Upon a major capital event, developer would be allocated the first gain, in an amount equal to its deemed capital contribution
  - In our example, upon a sale of the project, the developer would be allocated $300,000 of gain before any other partner received an allocation
- Risk for developer: there is not enough gain from sale of project
  - To the extent there is not enough gain to be allocated to the developer, the amount distributable to the developer must be reduced, dollar for dollar
  - Thus, developer would not receive entire $500,000 payment

Issue: Phantom Income

"I'm a developer. My investor is going to contribute $10 million and we're going to develop property into lots for sale. There also will be $20 million of development financing. The term sheet provides that the investor will get its $10 million back and then we will split all the profits 50/50. How will taxable income be allocated?"

Example: Phantom Income

- Income will be allocated 50/50 between the developer and investor
  - Even during the periods of time when all cash is being used to pay debt service and/or distributions to investor representing a return of his $10 million capital contribution
- As a result, developer would be allocated income in the early years of the partnership without receiving a corresponding, or any, distribution of cash
  - Example: In year 3, the partnership has $2 million in cash flow and $2 million in income
  - Investor:
    - $1 million income allocation
    - $2 million cash distribution
  - Developer:
    - $1 million income allocation
    - $0 cash distribution
  - Developer would have a tax liability of approximately $370,000 and no cash to pay it

Issue: Phantom Income

"I don't want to receive allocations of income without receiving cash."

Solution: Tax Advance or Distribution

- To ensure that developer receives cash to pay the taxes on its allocation of income, include a tax advance or distribution provision
  - Whether payment is treated as a distribution or advance is a business point
- Tax distributions are true distributions in the waterfall
- Tax advances are not included in the waterfall
  - Advances on future distributions, decreasing future distributions dollar for dollar
- Generally, neither tax advances or distributions should apply on liquidation of partnership
- Lenders often allow tax distributions or advances, but make sure the partnership provisions are consistent with loan documents
- Provisions to consider
  - Include state and local taxes, if applicable
  - Take character of income (capital gains or ordinary income) into account
  - Take prior losses into account
  - Take other distributions during the tax year into account
  - Clawback of over-advances upon liquidation of the partnership

Issue: Sale of Property to Development Entities

"I have land that's been in the family for generations. It's worth a whole lot of money but I'm told I can make even more money if we develop it into residential and commercial tracts. I've had a developer approach me and propose that I contribute the property at its current fair market value and that will be my capital contribution and I'll have a priority return on that capital contribution. Then the venture will develop the property and sell the commercial and residential lots and I'll make a fortune. I need for you to structure a joint venture agreement that provides for my capital contribution of property worth $45 million where I get the value of my property back first and then we split the profits 50/50."

Solution:
Sale of Property to Development Entities

- If the property is contributed, the original owner would be foregoing capital gains now for ordinary income later
  - Property owner would not receive any cash upon contribution
  - When partnership sells lots, sales would result in ordinary income
  - Even to the extent attributable to the appreciation in value of the property before contribution
- Solution: sell the property to the partnership, instead of contributing
  - Property owner can lock-in capital gains, based on the property's appreciation
    - Should get an appraisal and obtain highest price possible
  - Any gains from the sale of lots by the partnership would still be ordinary income
- Trap: original owner cannot own more than 50% of the partnership
  - Sale of property is ordinary income when:
    - Property is not a capital asset in the hands of the purchasing partnership, and
    - Sale is by person that owns, directly or indirectly, more than 50% of the capital or profits interests of the purchasing partnership

Issue:
Sale of Property to Development Entities

"What if the developer puts in capital, the partnership buys the land, he gets return of that capital and then I get 60% of the profits thereafter?"

Solution:
Sell to an S Corporation

- The original property owner cannot sell the property to the partnership and recognize capital gain
  - Because he owns more than 50% of the profits interests of the partnership, the sale would result in ordinary income
- Original owner could form an S corporation and sell the property to it, recognizing capital gain
  - Original owner would own 100% of S corporation, which could then contribute the property to the partnership for development
- The 50% ownership rule does not apply when an individual sells the property to an S corporation
  - Even if the S corporation has identical ownership to the ownership of the property
  - Note: partnerships that own property can also sell to S corporations (even with identical ownership) and recognize capital gain

Issue:
Sale of Property to Development Entities

"What if I just want to develop the property myself so that I get 100% of the profit?"

Solution: Sell to an S Corporation

- If the original owner developed the property himself and sold lots, he would recognize ordinary income
  - Even to the extent attributable to the appreciation in value of the property before contribution
- Original owner could form an S corporation and sell the property to it, recognizing capital gain
  - 50% ownership rule does not apply on a sale to an S corporation
- S corporation would then develop the property and sell lots
  - Sale of lots would still result in ordinary income

Issue: Disguised Sale

"I want to contribute property to my partnership. Once I do, the partnership is going to borrow money and then distribute cash back to me."

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Disguised Sale

- This is probably treated as a disguised sale of property by the partner to the partnership
  - Generally, if a partner contributes property to a partnership and within 2 years receives a distribution, the disguised sale rules presume that the transaction was part of a taxable sale
- Exception: debt-financed distributions
  - Traceable to partnership borrowing and the amount of the distribution does not exceed the contributing partner's share of the debt
  - All debt is treated as nonrecouse for purposes of determining a partner's share
    - Contributing partner cannot guarantee the debt to increase its share and avoid disguised sale treatment
- Exception: reimbursement of preformation capital expenditures
  - Reimbursement for certain capital expenditures made within 2 years before the contribution of the property to the partnership are generally not disguised sales

Issue: Partnership Audit Rules

"I'm purchasing the interests of a partnership which owns a project, rather than the project itself. What happens if the partnership has tax liabilities from before I acquire it?"

Partnership Audit Rules

- All partnership audits and tax assessments are implemented at the partnership, not partner, level.
  - The “partnership representative” has sole power (unless limited by contract in the partnership agreement) to deal with the IRS on behalf of the partnership
- When an audit results in an underpayment, the default rule is that the partnership will pay the taxes itself
  - Current partners will effectively bear the tax burden
- A partnership may elect to “push out” the taxes to the partners
  - Election causes partners in the reviewed year (not the current year) to pay taxes, even if they’ve left the partnership
- Purchase agreement should contain indemnities from selling partner with respect to pre-closing tax years
  - Consider amending partnership agreement to make “push-out” mandatory

Issue: Like-Kind Exchanges

"My partner and I each own 50% of two partnerships. We want to go our separate ways. I'm going to exchange my interest in partnership A for his interest in partnership B."

Like-Kind Exchanges

- The exchange of partnership interests would be a taxable transaction for each partner
- Under the 2017 Tax Act, only real property is eligible for like-kind exchanges
  - Partnership interests are not treated as real property, even if the partnership solely holds real property
  - Before the 2017 Tax Act, partnership interests were expressly excluded from like-kind exchanges
- Partnerships may utilize like-kind exchanges when disposing of real property

Issue: Opportunity Zones

“I understand my property is located in an area that might be an ‘opportunity zone.’ How does that help me?”

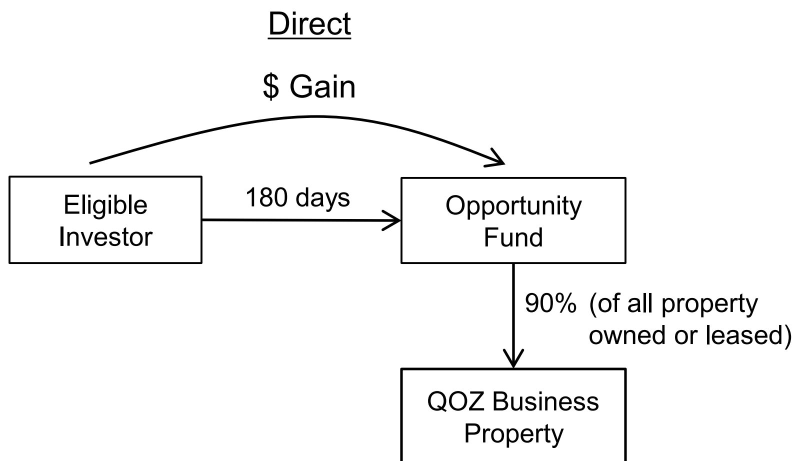
Opportunity Zones

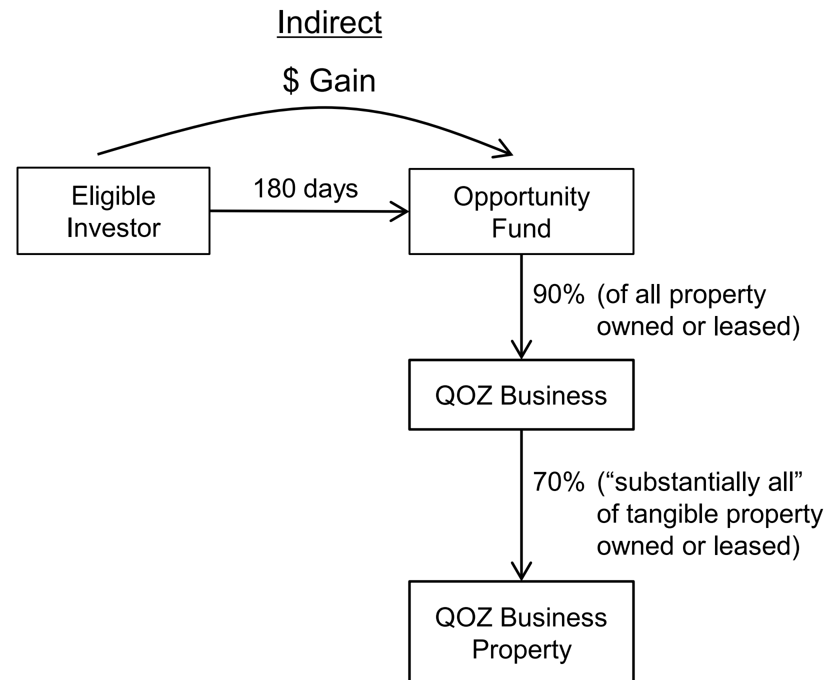
- The 2017 Tax Act created the opportunity zone program to encourage investment in low-income communities
  - Tax benefits may make it easier to raise money from investors
- Eligible Investors must reinvest eligible gains in a qualified opportunity fund within 180 days
- Eligible Investors
  - Any person that recognizes capital gain for tax purposes
- Eligible Gains
  - Any gain taxable as capital gain, including long-term, short-term and 1231 gain
- Qualified Opportunity Fund
  - A partnership or corporation that self-certifies as a qualified opportunity fund on an IRS Form 8996
  - 90% of total assets (owned or leased) are qualified opportunity zone property
  - Qualified opportunity zone property means QOZ business property (tangible property used in a trade or business in a QOZ) and QOZ business interests (stock and partnership interests)

Opportunity Zones

- Benefits
  - Capital gain that is invested in an OZ fund or business is not taxed until the disposition of the investment or 2026, if earlier.
  - 10% of the original gain avoids tax if held 5 years, 15% if held 7 years
  - Future appreciation of the investment is not taxable at all, if held for 10 years
- Example
  - Taxpayer sells stock on January 1, 2019 for $2 million capital gain. Invests the $2 million in an OZ fund within 180 days.
  - If taxpayer sells interest in the OZ fund on December 31, 2029 for $3 million:
    - No tax on the $2 million of capital gain until December 31, 2026
    - 15% of the original $2 million capital gain is excluded from tax
    - The additional $1 million of gain from the 2029 sale is excluded from tax

Opportunity Zones





Thank you!

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