A New Day: Emerging Issues in Real Estate Capital Markets

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Tax Developments Impacting Real Estate Capital Markets Participants

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Today's Presenters

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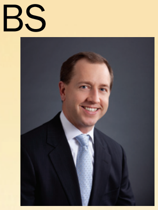

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Today's Agenda

- Recent Developments in the Taxation of Fund "Carried Interests"
- The Current Legislative Landscape Impacting Real Estate Capital Markets
- Recent Tax Developments Impacting REITs and Distressed Debt Funds

Treatment of Equity Received for Services

- Corporations
  - Vested stock grants are taxable as ordinary income to service provider upon issuance based on then FMV. FMV typically not based on liquidation approach.
  - Unvested stock grants are taxable to service provider upon vesting based on then FMV (i.e., taxation deferred until vesting).
    - If service provider makes Section 83(b) election, stock is treated the same as if it were fully vested upon grant (i.e., taxable at FMV at that time).

Treatment of Equity Received for Services

- Partnerships
  - Partnership interest grants are taxable as ordinary income to service provider upon issuance based on then FMV when the interest reflects an immediate interest in the capital of the partnership (a "capital interest"). Similar to the rules applicable to a corporation.
  - Different rules apply where the grant of the interest does not reflect an immediate interest in the capital of the partnership (a "profits interest").

The Profits Interest

- Non-taxable to service provider upon grant.
- Service provider is treated as a partner for tax purposes which means receives a K-1 and an allocable share of partnership income or loss. Upon disposition of the interest, the transaction will potentially give rise to capital gain (long term if held more than 1 year).
- If vesting, a Section 83(b) election is not technically required although a protective filing is usually good practice.

Creating the Profits Interest

- Requirements for "profits" interest favorable tax treatment (IRS Rev. Proc. 93-27 and 2001-43):
  - Received for services provided to or for the benefit of the partnership
  - No "capital account" credit on date of issuance (liquidation test)
  - Does not fall within one of the exceptions
  - Vesting does not impact the tax treatment (i.e., no tax on grant or on vesting)

Taxation of Fund "Carried Interests"

- Carried interests are interests provided to service providers which disproportionately reward them for their services in excess of the return expected for their cash capital contribution, if any.
- While carried interests are very similar to profits interests, technically the profits interest rules do not apply where the interest is "mixed" (i.e., contribution of services and cash).
  - Nonetheless, most tax practitioners bifurcate the interest and treat the "pure carry" as a profits interest.
- The obvious benefit is that there is no compensatory treatment associated with the grant or vesting. Profits interest holder receives allocation of partnership income which retains character (i.e., LTCG, etc.).
- General Partners/Managing Members of Real Estate and other private equity funds routinely receive carried interests in the fund which receive this favorable tax treatment. In addition, the general partner/managing member may also issue profits interests to certain of its employees so that they share in the carry without having to recognize taxable income at the time of grant.

Congress Takes Notice

- 2002-2007: High profile IPOs involving private equity fund managers (Blackstone, Fortress, etc.). Large amounts of cash out to founders as LTCG. Lots of "negative" attention in the press to this favorable tax treatment.
- Influential law review article written by law professor questioning historic tax treatment of "profits" interests (Fleischer, "*Two and Twenty: Taxing Partnership Profits in Private Equity* Funds," Univ. of Colorado (Aug. 2, 2007). Others soon follow.
- Congress takes notice. Legislative proposals beginning in 2007 to change this historic tax treatment.
  - June 2007 Baucus/Grassley bill introduced (S. 1624) which modifies the publicly traded partnership rules. Focuses primarily on funds tapping public market.
  - Broader proposal passed by the House (H.R. 2834) in December 2009.

Proposed New IRC Section 710

- Applies special rules with respect to an "investment services partnership interest."
- Statute works generally by treating the "distributive share" of income from an "investment services partnership interest" as ordinary income (including gain on sale) and potentially subject to self employment tax as well.
- While income allocated to such interest is ordinary, losses are ordinary as well. Losses are limited to the amount of prior income recognized but are limited to prior allocations of income.
  - While losses are often limited anyway, sometimes losses can be taken if there is third party financing present and this proposal would restrict the ability to take those losses.
  - Any gain on the disposition of an "investment services partnership interest" is treated as ordinary income and shall be recognized notwithstanding any other tax deferral or other provision that might apply. Not clear if this is intended to overrule deferral provisions such as the partnership merger rules or a "deemed termination" under Section 708.
- In-kind distributions by the partnership to a partner holding such an interest triggers taxable gain or loss to the partner as if the distributed property were sold by the partnership. This rule is similar to the rule that applies to corporations (except that it applies only to the holder of the investment services partnership interest) but is a significant change to the general rules applicable to partnerships.

Definition of Investment Services Partnership Interest

- "Investment services partnership interest" is an interest in a partnership held by a person that directly or indirectly provides a substantial quantity of a certain type of service with respect to certain types of assets.
- The specified assets are: Securities; real estate held for rental or investment, commodities, or options or derivatives with respect to such items.
- The specified services are: Advising on purchase/sale; managing such assets, arranging financing or supporting any of the foregoing.

Open Questions Related to Definition of Investment Services Partnership Interest

- What is a substantial quantity of services?
- Can you bifurcate services into related entities to avoid tainting "good" services with "bad" services and keep a portion of the carry safe?
- How does definition of real estate apply to operating real estate such as a hotel or nursing home? Could these rules apply to partnerships holding these types of assets which are not funds (e.g., no outside investors, etc.).
- If concerned about real estate used in a business, can that be held by a related entity and not taint a profits interest in the operating entity?

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The "Good" Portion of the Carry

- If any portion of an investment services partnership interest is a "qualified capital interest," then the ordinary income rules do not apply to that portion.

- BUT: The portion acquired with invested capital must receive allocations which are pro rata with other invested capital which is not providing services. Interesting question arises where there are multiple classes of cash investors. What exactly is "pro rata with other invested capital which is not providing services" in that case?

- ALSO: Invested capital DOES NOT include any amounts if attributable to a loan from (or guaranteed by) any other partner or the partnership.
  - What about if the service provider contributes a demand note? Can that count as money or other property?

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Definition of Qualified Capital Interest

- The portion of the partner's interest in the capital of the partnership as is attributable to :
  - Fair market value of any money or other property contributed
  - Amounts included in income under Section 83 (i.e., a compensatory grant of the interest but of a capital interest and not a profits interest such that it was taxable at grant)
  - Amounts which have already been taxed but for which that income has not given rise to a distribution (i.e., undistributed taxable income)
  - Interest purchased with loan proceeds where the loan was made or guaranteed by partner or partnership (or related person) does not qualify.

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Investment Management Services

- Proposed legislation contains a special rule that provides that if a person provides one of the enumerated services, certain quasi-equity interests will be treated as giving rise to ordinary income.
- Applies to certain types of instruments where the value is substantially related to the amount of gain from the assets with respect to which the services are provided.
- Really meant to get at synthetic equity structures.

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Application to REITs

- REITs generally must receive 95% of its gross income each year from certain sources (i.e., interest, dividends, rents from real property, gain from real property other than "dealer" property). REITs also must receive 75% of its gross income each year from real estate related sources (such as rents from real property, interest on mortgages, gains from sale of real property other than "dealer" property, etc.).
- Compensation income for performance of services generally does NOT count as "good" income under either the 95% or 75% tests. New Section 710 would treat allocations from "investment services partnership interest" as "ordinary income." Prior versions of the proposed rule characterized this as income from the "***performance of services***."
- Many types of REITS (such as joint venture REITS, etc.) regularly hold carried interests in partnerships.
- Prior versions of the proposed rule contained a special rule for REITs holding investment services partnership interest: the ordinary income rules apply but not "bad" income. On the other hand, such amounts likely are still OI as distributed to shareholders (i.e. no "capital gain" pass-through).

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Planning

- What can or should be done today?
  - Consider avoiding "mixed" carried interests
- Grandfathering?
- The 40% cudgel – plan at your own risk.
- Ideas:
  - Simple – Change the fund economics or include gross-up provision. This may not be as dramatic as you think.
  - Make the carry a capital interest and work on the valuation angle.
  - Contribution of demand note.
  - Third party borrowings.

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The Legislative Landscape

- Likelihood of enactment of carried interest tax legislation? Likelihood of other legislative developments impacting Real Estate Capital Markets?
- Impact of recent Senate elections in Massachusetts.
- Status of Estate Tax "Repeal," expiration of Bush Tax Rates.
- Impact of Health Care debate and record deficits.

> *"[A]t a time of record deficits, we will not continue tax cuts for oil companies, **for investment fund managers**, and for those making over $250,000 a year. We just can't afford it."*
>
> -President Obama, State of the Union Address (1/27/10) (emphasis added).

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Recent Tax Developments Impacting REITs

- IRS extends REIT stock dividend concession.

  --REITs required to distribute 90% of taxable income to maintain REIT status. Disadvantage as compared to non-REIT corporations in terms of preserving cash by reducing dividends.

  --Rev. Proc. 2008-68 confirmed ability of REITs to declare dividends with shareholders electing to receive additional shares or cash, with cash capped at 10% of the aggregate declared dividend.

  --If too many shareholders elect to receive cash, each electing shareholder gets pro rata portion of the 10% cash.

  --Original safe harbor only applied only to distributions related to taxable years ending on or before 12/31/09, BUT new Rev. Proc. 2010-12 extends this for two additional years (i.e., to distributions declared on or before 12/31/12 with respect to taxable years ending on or before 12/31/11).
- Complications in utilizing stock dividends:

  --Rev. Proc. 2010-12 technically only applies to listed REITs, though same standards should apply to non-traded and private REITs.

  --Complex disguised sale tax analysis is required for Up-REIT structures.

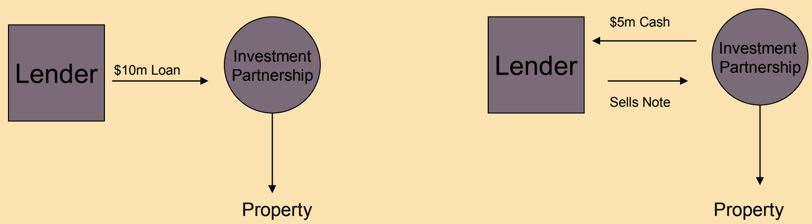
Key Tax Issues for Private Equity Investments in Distressed Debt

Common Transactions

- Debtor repurchases its own debt and/or negotiates write-down with lender.
- Related party repurchases debt from the lender.
- Unrelated party purchases debt (Distressed Debt Funds).

Debtor "Repurchases" Own Debt

Example #1: Investment Partnership borrows $10m to purchase an office building in 2005. During 2009, the Investment Partnership repurchases the debt from the lender for $5m.



Result: Investment Partnership has $5m of taxable COD income. Same result if borrower and lender instead negotiate a reduction in the debt from $10m to $5m.

Potential Solutions: Structure to qualify for exceptions or deferral.

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Key Exceptions to COD Income Recognition

- Debtor is insolvent or bankrupt at the time of the write-down.
  - Trade off is reduced tax attributes (such as NOLs, tax basis, etc.)
- "Qualified real property business debt."
  - Debt incurred in trade or business and secured by real estate.
  - FMV of real estate required to be less than debt.
  - Trade off is reduced basis in depreciable real estate.
- New Code Section 108(i) added in 2009 allows deferral of COD income realized in 2009 and 2010 if requirements met.
  - Debtor is a C corporation or incurred debt in a trade or business.
  - COD Income recognized ratably over 5 years beginning in 2014.
  - New Rev. Proc. 2009-37 provides favorable guidance
- Purchase Price Reduction if debt issued to seller of property.

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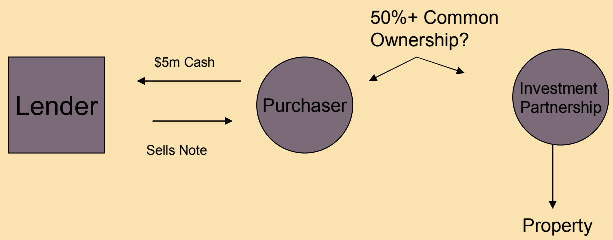
Related Party Purchases the Debt

Example #2: Same as in Example #1 except that "related" party purchases the note and the debt remains outstanding.



Result: If Purchaser is "related" to borrower (as defined in Sections 267/707 of the tax code), then Investment Partnership has $5m of taxable COD income unless exceptions apply. Also, Purchaser has $5m of "phantom" interest income over the remaining life of the note (and borrower has deduction).

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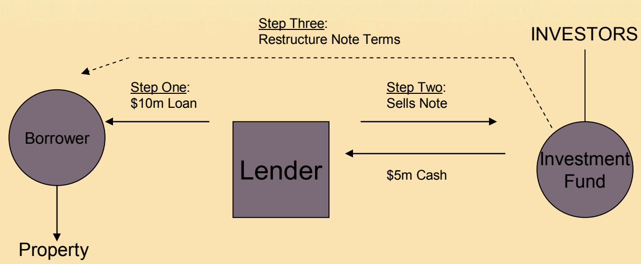
Unrelated Party Purchases the Debt

Example #3: Same as in Example #1 except that "unrelated" party purchases the note and the debt remains outstanding.



Result: It depends. If debt is NOT publicly traded then (generally) borrower is neutral and investor has adverse tax consequences. If debt is publicly traded, then both parties may have adverse tax consequences.

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Unrelated Party Purchases Debt

Non-Publicly Traded Debt

- "Significant" modification of the debt terms following acquisition (extension of maturity, adjustment to yield, etc.) will create a deemed exchange of "old" note for "new" note with modified terms.
  - **For Borrower:** $10m face of new note repays in full the $10m "old" note. Thus no COD income.
  - **For Investor:** $10m face amount of "new" note issued in exchange for "old" note ($5m tax basis) results in $5m of STCG!!!!!
  - **Potential Solutions:** Could be tax-free if borrower is a corporation. If partnership/LLC borrower, might qualify under "installment method" of deferred reporting, subject to $5m limits. Also can maybe avoid taxable exchange if modifications are done prior to purchase.
- If non-publicly traded debt is not significantly modified, then purchaser has $5m of "market discount."
  - **For Investor:** Market Discount accrues over the remaining term of the note and then, to such extent, is taxable as OI, not capital gains.
  - **Potential Solutions:** Possible exception for defaulted/deeply discounted debt?

Unrelated Party Purchases Debt

Publicly Traded Debt

- "Significant" modification of the debt terms following acquisition (extension of maturity, adjustment to yield, etc.) will create a deemed exchange of "old" note for "new" note with modified terms.
  - **For Investor:** $5m FMV minus $5m basis equals $0 gain.
  - **For Borrower:** $5m FMV new note issued in satisfaction of $10m face old notes creates $5m of COD income!!!!! Same general COD exceptions could apply, including new deferral rules.
- If publicly traded debt is not significantly modified, then purchaser has $5m of "market discount" which accrues and then, to such extent, is taxable as OI, not capital gains.
  - Possible exception for defaulted/deeply discounted debt?

Distressed Debt Funds
Additional Phantom Tax Issues

- Holder of note acquiring title to the collateral (e.g., through foreclosure, deed in lieu, etc.) can trigger additional phantom tax gains to holder to the extent the FMV of the collateral exceeds the holders tax basis in the note.

- Example #4: Investment Fund acquires a $10m face amount note for $5m. Then, at a time when the underlying collateral FMV is, say, $7m, the Investment Fund (through foreclosure, deed in lieu, etc.) obtains title the collateral. Result: $2m taxable gain to Investment Fund (possibly OI under the market discount rules).

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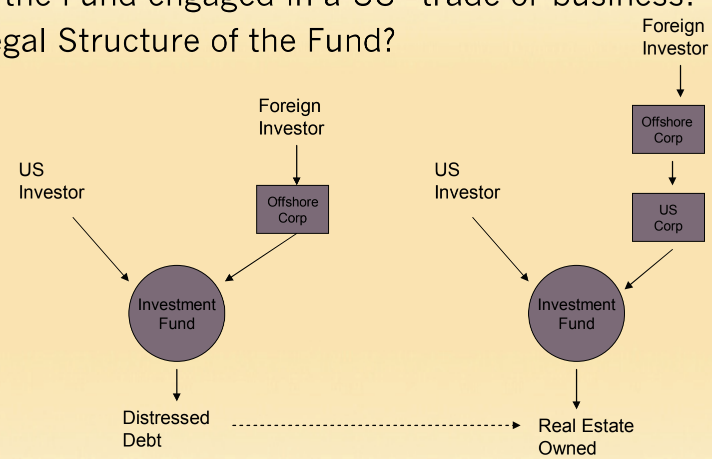
Distressed Debt Funds
Special US Tax Issues for Foreign Investors

- Is the Fund engaged in a US "trade or business?"
- Legal Structure of the Fund?



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Questions and Answers

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