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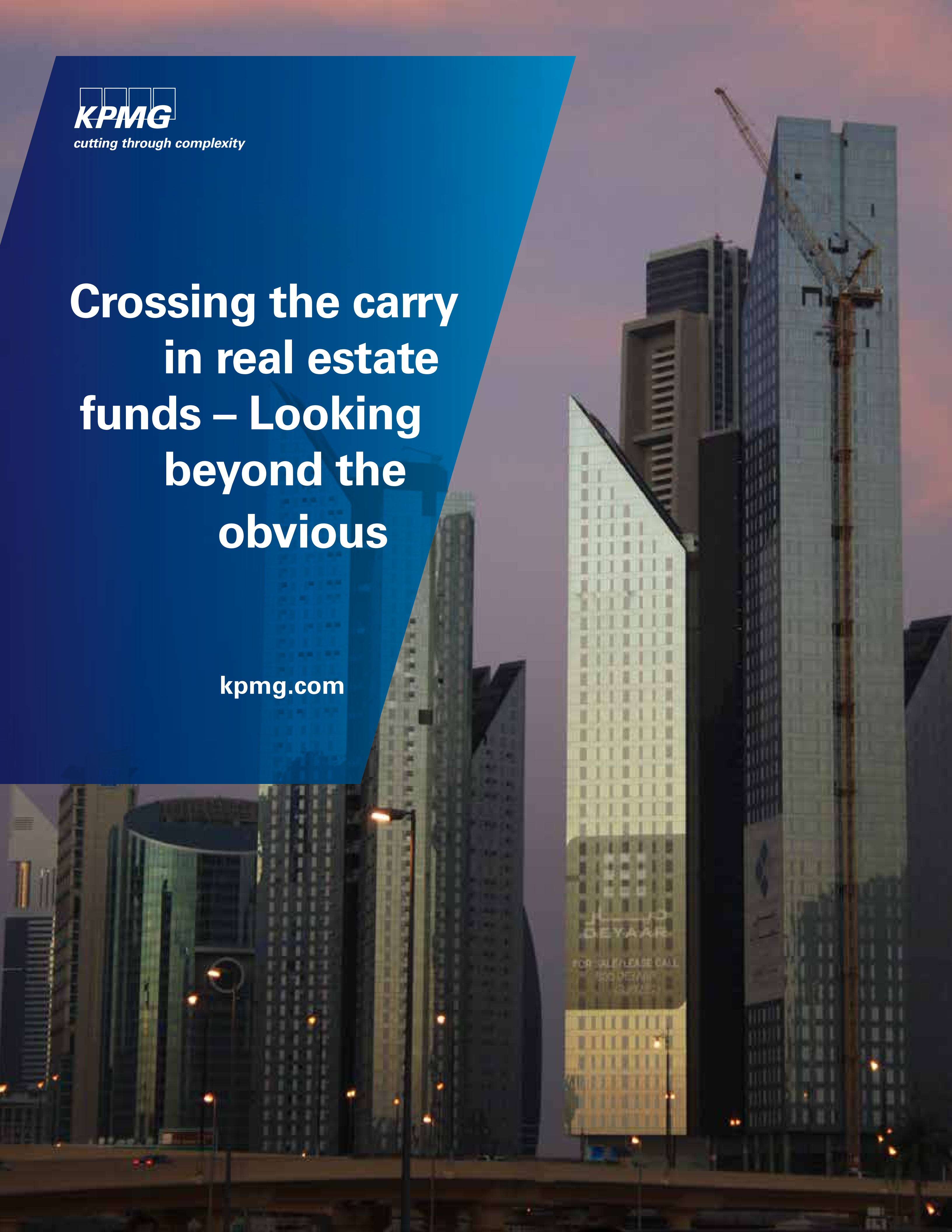
Crossing the carry in real estate funds – Looking beyond the obvious



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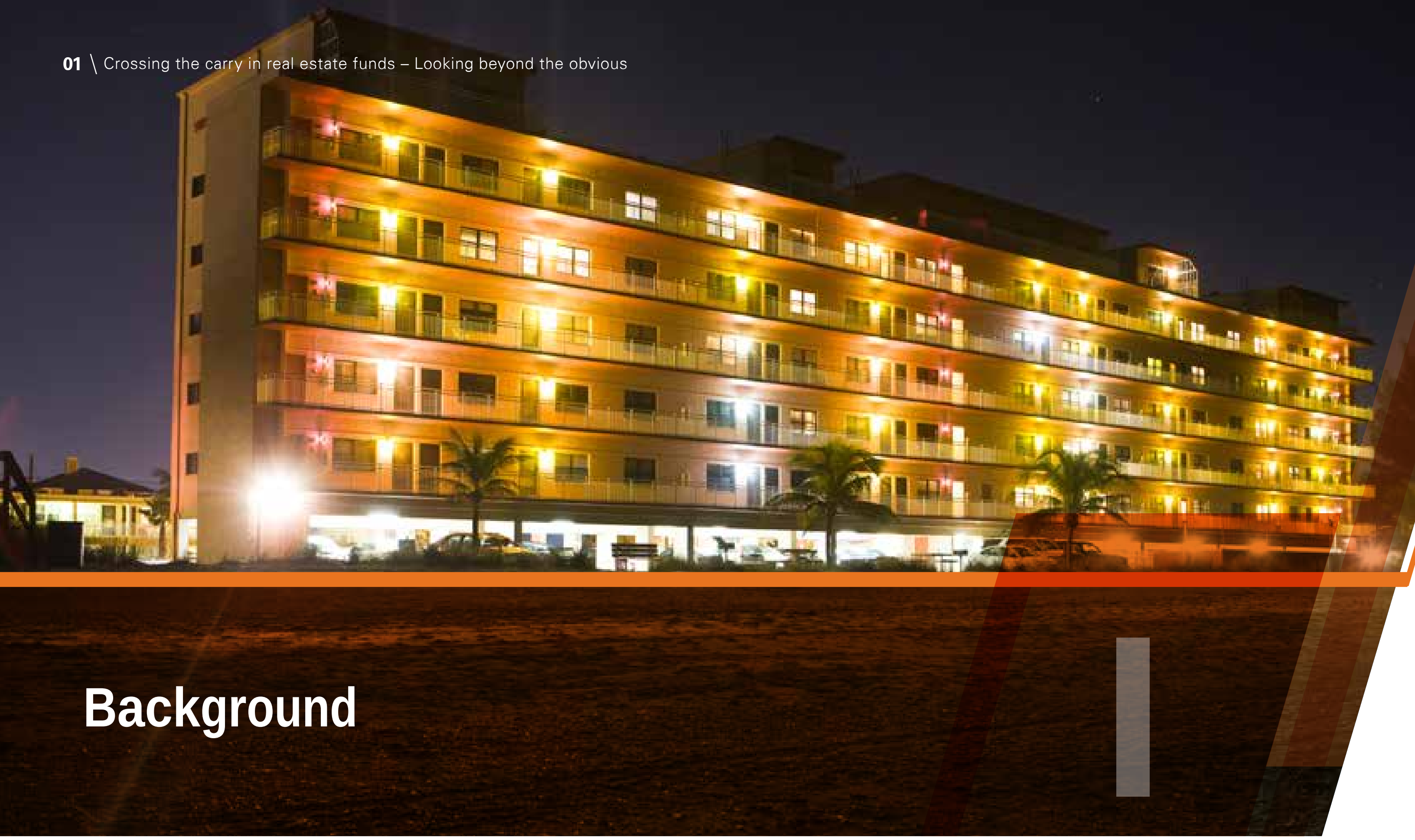

Background

In recent years, the pressure for fund sponsors to accommodate tax sensitivities for a wide range of investors has become more intense. Parallel funds, each structured to meet the needs of a specific investor class (e.g., non-U.S., section 892 governmental, tax-exempt, qualified organization, state pension, etc.), have become the rule rather than the exception.

"Blocker corporations" play an increasingly significant role in structures for certain types of investors. But blocker corporations create tax leakage related to entity-level tax or inability to flow through losses, so there is incentive to "block" investments only to the extent necessary. In addition, if certain "blocker" entities are available and more efficient for a particular investment, a significant investor may bargain for use of the more efficient entity for the qualifying properties. For example, for certain U.S. properties, a real estate investment trust (REIT) may convert the character of income earned at the property level (e.g., Unrelated Business Taxable Income (UBTI), Effectively Connected Income (ECI), commercial activity) to more beneficial dividend income without any entity-level tax so long as all income is distributed on an annual basis. Similarly, for non-U.S. properties, a foreign corporation formed in certain jurisdictions may avoid any material entity-level tax. The result is that an investor, such as a non-U.S. or section 892 governmental investor, may require investment in REIT-eligible investments through a REIT, non-REIT eligible U.S. investments through a domestic C corporation, and non-U.S. investments directly or through a non-U.S. corporation.

Structures that accommodate the tax sensitivities of fund investors may be inconsistent with the tax goals of the fund sponsor. A U.S. sponsor does not have the same tax sensitivities as the investors who utilize the blocker corporations, and the tax leakage attributable to the blocker corporations would produce inefficiencies for the U.S. sponsor. Specifically, a blocker entity that is taxed as a C corporation generally will reduce the after-tax income earned with respect to an investment and hence the "carried interest" paid to a U.S. sponsor. So the obvious decision would seem to be for the U.S. sponsor to avoid the leakage by taking its carried interest underneath the blocker corporations.

Given that the investor will invest through different types of blocker entities depending on the profile of the particular investment, the U.S. sponsor generally will form different partnerships into which the separate blocker entities will invest. As a result, the U.S. sponsor must take its carried interest in different partnerships that hold isolated portions of the overall investment portfolio.

From the investor's perspective, it would not be appropriate to evaluate the U.S. sponsor's performance by reference only to the specific investments in each separate partnership. If one partnership's strong performance is offset by losses in another partnership, the investor would not view the U.S. sponsor as properly earning a "carry." Accordingly, the investor generally will require that the U.S. sponsor calculate its carried interest (including any "catch-up" distributions[1]) by reference to the entire investment portfolio (i.e., "cross" the carried interest across all partnerships), and not by reference to the individual partnerships through which the various investments are held.

Structures involving a "crossing" of the carried interest among multiple partnerships have been utilized in the private equity context for a number of years. Only recently, however, have such arrangements become in vogue for real estate funds. While the transition from private equity to real estate might seem like a natural phenomenon, there is a significant difference between funds investing in these different types of assets. That is, the carried interest in domestic private equity funds often is paid on an "investment-by-investment" basis, so that disposition proceeds for an investment will return capital and pay preferred return only with respect to a sold investment before paying carried interest to the sponsor (as long as there is no shortfall with respect to previously disposed investments). By contrast, the carried interest in real estate funds typically is paid only after all investors have received distributions equal to their ***entire*** invested capital and preferred return (a "cumulative waterfall").[2] As will be described below, the difference in cash flow priorities can make the crossed carry a somewhat less comfortable fit for real estate funds.

The issue most often discussed in situations involving crossed carried interests among various partnerships is the fear that the various partnerships will be collapsed into a single partnership. The combining of economics and certain other factors[3] can create risk that the partnerships will be treated as a single partnership. The results of such a characterization can be catastrophic, as non-REIT income may be allocated to REITs, U.S. effectively connected income may be allocated to non-U.S. blocker corporations or directly to a non-U.S. investor, and non-U.S. income may be allocated to U.S. blocker corporations.[4] Obviously, partnership withholding liability could be implicated by a reallocation of U.S. income to a non-U.S. taxpayer.

This paper does not discuss in detail the risk of collapsing the partnerships. This paper assumes that the partnerships will be respected as separate. There are, however, numerous issues and challenges beyond the collapsing of multiple partnerships that must be considered in structuring and operating the multiple partnerships, and these are the focus of this paper.[5] Chief among the challenges can be the calculation and allocation of income and loss among the participants in the various partnerships in a way that gives credence to the separate nature of the partnerships. Other structural and operational issues also deserve mention and will be discussed below.

[1] A "catch-up" distribution generally provides that, once the limited partners (LPs) have received their designated internal rate of return (IRR), the general partner (GP) will receive a disproportionate portion of the distributions (larger than the baseline carried interest percentage which generally is 20 percent) until the GP has received an amount equal to the baseline carried interest percentage multiplied by total partnership distributions, excluding distributions that reflect a return of contributed capital. In effect, the GP is permitted to "catch up" to the return of the LPs as if its percentage interest in overall partnership profits was equal to its baseline carried interest percentage.

[2] In the United States, the cumulative waterfall often is referred to as a "European-style" waterfall because private equity funds promoted in Europe typically use such a waterfall. In Europe, the cumulative waterfall often is referred to as a "whole-fund" waterfall.

[3] Other factors linking the various partnerships may include (1) coordination of capital default and remedy provisions, (2) application of leverage limitations by reference to investments across all partnerships, (3) application of limitations on concentration of asset-types across all partnerships, (4) a single advisory board for all partnerships, and (5) application of financing, acquisition, and disposition fees in a single partnership to reduce management fees across all partnerships.

[4] Taxpayers may argue that, even if the partnerships are collapsed into a single partnership, the deemed single partnership should be treated as having allocation provisions that track from the separately formed partnerships to the partners that actually own interests in those separate partnerships. Given, however, that distributions from any given investment are made by reference to the total capital invested with respect to all investments (i.e., proceeds from the disposition of one investment are applied to return all capital and pay the preferred return on all contributed capital), there would seem to be some risk that, in accordance with the substance of the arrangement, allocations to LPs with respect to any investment should simply be made pro rata to the various LP-investor entities by reference to relative contributed capital to the combined partnership. The risk that the tracked allocations will not be respected would seem to be greatest where allocations made on a separate entity basis do not actually result in capital accounts that match the cash entitlements with respect to such entities.

[5] Many of the issues described below also may arise if multiple blocker entities invest in a single partnership with special allocations effectively tracking ownership of specific investment assets to specific blocker entities. The tracking of investments to separate blocker entities within a single partnership that has a cumulative waterfall presents the potential to return capital from one tracked investment using proceeds from the disposition of a different tracked investment. The tracked investment that is disposed of later then may be used to fund a distribution under the carried interest tranche. In effect, this arrangement presents the scenario that would arise if, as described in the prior footnote, the multiple partnerships that are the subject of this paper are collapsed into a single partnership, and the determination must be made as to whether the isolated allocations of the separate partnerships will be respected.

Challenges in allocating income

The challenge in undertaking allocations is obvious, given that the economics with respect to the U.S. sponsor and ultimate investor are being determined as if the separate partnerships were, in effect, a single partnership. As a result of this dynamic, capital invested in one partnership may be treated as returned under the distribution waterfall using cash attributable to profit generated in another partnership. The proper way to allocate such profit within the confines of the partnership that produces the profit often will be unclear.[6]

It is important to recognize the interrelationship between the allocation of income and loss by the partnerships and the strength of the position for respecting the multiple partnerships as separate for U.S. income tax purposes. Under the applicable rules, allocations of income and loss must be reflective of the partner's economic rights associated with the items. If allocations cannot be accomplished on a separate partnership basis in a manner that is consistent with the economic rights of the partners in those separate partnerships, the support for respecting the partnerships as separate may be compromised.

When the carried interest is crossed among multiple partnerships utilizing a cumulative distribution waterfall, at any given time, it may not be possible to determine with certainty how cash will be divided in any given entity. That is, it is not clear what, if any, portion of a catch-up or carried interest distribution to the sponsor will be paid by each lower-tier partnership until such payments are actually made.

On a single-partnership basis, allocations of profit generally would be made in advance of distributions under the catch-up and carried interest tranches to build capital accounts

[6] The relevant fund agreements typically propose a "targeted" allocation methodology, with an ability on the part of the GP to override the results if it deems advisable. While providing significant flexibility, such allocation terms provide no material guidance as to how allocations should be undertaken within a given partnership.

consistent with the ultimate distribution entitlements upon liquidation. But because, in a separate partnership arrangement with a cumulative waterfall, it often will be impossible to know how cash ultimately will be distributed from a given partnership, the allocation exercise for the separate partnerships may be more difficult. In addition, scenarios may unfold that result in one or more of the separate partnerships having insufficient items of income or loss to match the partners' economic entitlements.

A simple example is helpful to illustrate the most basic disconnects that can occur with respect to such arrangements. Assume the formation of two partnerships, each of which acquires a single investment for $100. The LPs are entitled to receive their capital and a 10 percent IRR with respect to both investments before the GP receives a 20 percent carried interest. The first partnership sells its investment for $220 at the end of one year, which will satisfy the LPs' total capital and IRR for both partnerships. Because of the overlapping economics, all cash from the first investment will be paid to the LPs, and that partnership will liquidate. If both investments were held in a single partnership, a portion of the $120 profit would be allocated to the GP, as the partnership still holds an asset with a $100 book value, and it would be presumed that the $100 will be paid, in part, to the GP to cover its carried interest. Assuming that the other investment ultimately will be sold for book value, a portion of the profit from the sale of the first investment truly will inure to the benefit of the GP.

In the example posited, however, the entity that is making the allocations had one asset, and because it is liquidating, it will never make a distribution to the GP. In order to properly reflect the economic arrangement with respect to that partnership, it would seem necessary to allocate all of the gain to the LPs. Such an allocation will cause the capital accounts of the LPs (which track economic entitlements of the partners) to match the distributions that they will receive on liquidation of that partnership.

Subsequently, the second partnership sells its asset for $100. The GP will receive part of this payment in satisfaction of its carried interest, as the LPs received all of their capital and 10 percent IRR through the first partnership's investment. However, this partnership has no income to allocate to the GP. Accordingly, the proper method of accounting for the GP's payment is not altogether clear. One way to reflect the GP's distribution could be to account for the payment as a guaranteed payment under section 707(c). While the propriety of such treatment is debatable, in the absence of profit to allocate and increase the GP's capital account to match the payment, there appears to be no better way to account for such a payment. The partnership's deduction attributable to the guaranteed payment presumably would create a loss that is allocated to the LPs, reducing their capital accounts to match the portion of their invested capital that is paid out to the GP.[7]

Another example is helpful in highlighting the challenges that must be confronted and discretion that must be exercised to allocate income and loss in more complicated arrangements. This time, assume that LPs have invested $400, $200 into two separate partnerships. Each partnership invests $100 in two separate properties. Again, the LPs are entitled to receive their capital and a 10 percent IRR with respect to all investments before the GP receives a 20 percent carried interest. Assume that, after one year, the first partnership sells a single investment for $200, recognizing gain equal to $100. Also assume that the second partnership has no income or loss for the year. Looking at the first partnership in isolation and applying the same cash waterfall as applies to the overall arrangement (i.e., 10 percent IRR followed by 80–20 carried interest), $20 would be allocated to the LPs to match their 10 percent IRR on $200 of contributed capital. The remaining $80 of profit would be allocated $64 to the LPs and $16 to the GP. Such allocations would provide a $16 capital account for the GP, anticipating that a carried interest will be paid from the first partnership.

[7] Some advisers assert that allocations may be undertaken by treating each partnership as a separate partnership with an isolated waterfall that equates to the overall deal. To the extent that distributions are not consistent with the allocations, the excess proceeds would be considered "loaned" by the partner who was entitled to the distribution on a separate partnership basis to the partner who actually received the distribution. Under this theory, in the example above, the first partnership would be treated distributing $20 to the GP (20 percent x $100 (profit available after $20 IRR)), and the GP would be treated as "loaning" $20 to the LPs. The LPs then would repay the $20 loan out of the $100 distribution they would receive upon sale of the second partnership's asset consistent with the LP's contributed capital to that entity. A number of problems exist with this approach. First, there generally is no indication of a "loan" in the documents that account for the economic arrangement. Second, there is no interest charged. Charging interest in such cases would alter the economic deal struck by the parties. Third, if losses occur in another partnership that offset the carried interest entitlement, there will be no obligation to repay the loan. Finally, because of the different blocker entities that generally will serve as the LPs in the different partnerships, the LP that repays the "loan" often would be a different person than the LP who was deemed to borrow the funds.

But note the variables relating to the second partnership that can affect whether the first partnership ultimately will pay a carried interest to the GP. First, if the first partnership sells its other asset before the second partnership makes any sales, presumably all of the sales proceeds will be paid to the LPs, given that, under the cumulative waterfall, LP capital contributed to the second partnership and the accompanying IRR must be satisfied from those proceeds. Second, property held in the second partnership ultimately may be sold for a large loss, thus eliminating the GP's right to the carried interest, as determined on a cumulative basis. But a loss recognized in the second partnership will not be available to reduce the GP's capital account in the first partnership.

This example highlights the discretion that must be exercised in making allocations in such situations. The goal is to allocate income and loss in a manner that will result in capital accounts matching distributions that ultimately will be made by each separate partnership. Thus, if the GP anticipates that the other property held by the first partnership will be sold before any properties held by the second partnership, presumably all profit from the first sale would be allocated to the LPs. Similarly, if the properties in the second partnership reflect significant losses, so that the GP anticipates that no carry ultimately will be paid by the first partnership, again the choice may be made not to allocate gain from the first property disposition to the GP. Of course, if the anticipated scenarios do not play out, the choice with respect to the allocation of gain from the first property sale, in hindsight, may have been incorrect. In addition, the ability to predict the timing of sales and performance of assets often will be highly uncertain.[8]

In general, the fewer partnerships and the more assets in each partnership, the easier these issues may be to negotiate. Fewer partnerships mean fewer scenarios that must be coordinated in making allocations in a given year. In addition, with more assets in the partnerships, it is more likely that sufficient items of income or loss may be available from late dispositions to "true-up" earlier allocations in a partnership that, in hindsight, may have been misguided. This is not to say that the issues described above will never arise in these situations. The ordering of asset sales and the performance of assets in the separate partnerships still may present significant challenges. But chances are better that the allocations ultimately may be made to correspond with the economic rights of the partners in each partnership.

By contrast, a structure in which each of many assets is held in a separate parallel partnership through a separate blocker entity will present significant challenges.[9] Each disposition will result in a liquidation of the single-asset partnership, so allocation of the gain for a given partnership generally may be determined by reference to the recipient of the cash that relates to the gain. But a significant carried interest may be earned under the waterfall, with such amount being paid upon the sale of some of the final assets in the structure. Often, the final assets sold will be those assets that have underperformed within the portfolio, and these sales may not generate sufficient gain to match the carried interest entitlement of the GP.[10]

[8] Note that revaluations of partnership assets for purposes of measuring capital accounts can present significant challenges in properly allocating the related gain. For example, consider a situation where a fund using multiple entities, a cumulative distribution waterfall, and a crossed carry issues additional profits interests to service partners at a time when assets have appreciated. The general practice would be to revalue partnership assets to fair market value to ensure treatment of the new interests as qualifying "profits interests" (i.e., so that the interests can only share in future appreciation in such assets). But obviously allocating the "book" gain resulting from the revaluation as if all assets were sold at one time can create real issues given that the ultimate distribution of the related proceeds may depend on the order in which the assets are sold. In these situations, consideration may be given to forgoing a formal revaluation and adjustment of capital accounts and instead providing for allocations of gain to the new profits interest holders only by reference to appreciation above the current fair market value of any given asset. This approach still would involve a determination of the current fair market value of each partnership asset as a benchmark for future allocations, but capital accounts would not be adjusted to reflect the new values.

[9] The use of separate partnerships and blocker corporations for each separate property may result from planning relating to potential Foreign Investment in Real Property Tax Act (FIRPTA), branch-profits, and/or withholding tax exposure.

[10] An additional issue that may be confronted in such structures relates to the allocation of management fee deductions among the entities to the extent that such management fees are attributable to committed capital that has yet to be contributed. More specifically, during the investment period, investors generally are charged a management fee based on a fixed percentage of committed capital. In situations where a different partnership is used for each investment, it may be unclear where deductions attributable to capital that has yet to be contributed should be allocated. The partnerships that will benefit from the management services related to future capital contributions have not yet been formed. In a more typical fund structure, this issue does not arise, as the investor is a member of a single entity that will invest all of the committed capital. Even when a separate partnership and blocker entity are formed for each investment, it often will be the case that investors are investing through a single overall partnership above the blocker entities and separate investment partnerships. In such situations, it may be appropriate to allocate the management fee deduction attributable to future capital contributions to the common partnership above the blocker entities.

The problem is particularly acute if the GP is entitled to a significant catch-up distribution under the waterfall. For example, if the distribution waterfall provides for a 100 percent catch-up distribution such that the GP catches up to 20 percent of total partnership distributions (ignoring returns of capital), then depending on the magnitude of the catch-up entitlement, it is possible that the GP could receive 100 percent of the distributions made by a separate partnership. On a separate-partnership basis, such distributions would provide no recognition of the capital contributed by the LPs, and it would be impossible for the partnership to have sufficient items of income or loss to reconcile liquidating distributions with the capital accounts of the partners. It seems likely that some guaranteed payment to the GP would be required.[11] If the partnership recognized no gain on the disposition, the entire liquidating distribution for that partnership could be a guaranteed payment, with the LPs' capital accounts being reduced to $0 through allocation of the related deduction.

[11] It should be noted that such an arrangement also entails risk of reallocation within the overall structure under section 482 (relating to arm's-length pricing), as the investors in the separate partnership, when viewed in isolation, would not likely negotiate an arrangement allowing an asset to be sold for its cost in a scenario where no capital would be returned to the investors.

Some consequences of the allocation challenges

The issues described in the prior section are important beyond merely highlighting the difficulties in properly allocating income. That is, in many situations, the allocations made within the separate partnerships that account for a cumulative cash waterfall will vary significantly from the allocations that would occur if all investments were held in a single partnership. These differences can have real consequences for the investors and the sponsor.

A. Carried interest as ordinary income to the sponsor

As described above, if the sponsor is entitled to a catch-up or carried interest distribution under the cumulative waterfall, but the partnership that makes the distribution has insufficient income or gain to account for the distribution, the excess distribution may be accounted for as a guaranteed payment that represents ordinary income.[12] Receipt of ordinary income to account for the carried interest distribution will come as a surprise to many sponsors.[13]

B. Acceleration of gain to LPs

As shown in the first example above, allocations on a separate partnership basis can result in significant acceleration of gain to the LPs. This result will be most likely in arrangements involving many different partnerships each holding a single property. The problem arises because gain that would be allocated to the GP as part of the catch-up or carried interest if all properties were held in a single partnership instead may be allocated to the LPs because the GP will not actually receive any distribution from the partnership that is disposing of the property.

[12] Note that there also could be situations where a guaranteed payment to the LPs may be advisable in order to reconcile capital accounts with the ultimate distributions for a separate partnership. For example, the GP may be allocated income from an early property disposition within a partnership to account for its carried interest, but subsequent transactions in other partnerships may offset the GP's right to a carried interest under the cumulative waterfall. If the remaining property in the first partnership subsequently is sold for no gain or loss, there may be no items to eliminate the GP's positive capital account absent reporting the LPs' distributions in excess of their capital accounts as guaranteed payments and allocating the related deduction to the GP to eliminate the GP's positive capital account. Issues related to the treatment of such guaranteed payments as UBTI, ECI, or commercial activity income must be considered if such reporting is made to the LPs.

[13] Some advisers assert that the excess distribution may be accounted for simply as a distribution under section 731 even though the sponsor's capital account would not justify such a distribution. Such reporting would seem difficult to support from a technical perspective. Gain recognized under section 731 does not represent income reported by the partnership to a partner but instead represents gain recognized by a partner with respect to its partnership interest (i.e., a transaction outside the partnership). Thus, gain recognized under section 731 cannot be viewed as providing for an economic entitlement of a partner with respect to partnership assets. As previously discussed, given the overarching goal of respecting the various partnerships as separate, it seems critically important to adopt some methodology of accounting for partnership economics that can reconcile cash received from a partnership with income or loss items reported to the partner by the partnership, and the use of the guaranteed payment does at least accomplish this important goal.

This result is less likely in a structure where few partnerships hold numerous assets, and each partnership sells assets at roughly the same rate. In this scenario, it is more likely that cumulative allocations across the multiple partnerships may roughly equate with the allocations that would be made on a single-partnership basis. An aberration in the projected sales pattern or proceeds may change this result though. If one partnership winds up selling numerous assets early and, in effect, returning capital and paying the preferred interest attributable to investments in other partnerships, material acceleration of gain to the LPs could occur.

C. Order of asset dispositions and types of income allocated to partners

If the carried interest is crossed among multiple partnerships utilizing a cumulative distribution waterfall, the ordering of asset sales can have a material impact on the tax results for the various partners. For example, assume a domestic-fund structure with tax-exempt investors where REIT-qualifying assets are held in a single partnership through a REIT blocker corporation and other assets are held in a single partnership through a domestic C corporation. Also assume that all assets held in the partnership owned through the C corporation blocker are sold for a significant gain prior to a sale of any REIT assets. By virtue of the cumulative distribution waterfall, a disproportionate amount of the cash attributable to the gain will be used to return capital invested in, and IRR earned with respect to, REIT assets, and a disproportionate amount of gain from the later sale of REIT assets will be used to fund the GP's carried interest. If, on a single partnership basis, a portion of the gain from the early asset sales would have been allocated to the GP to fund its carried interest, the separate partnership structure will result in more gain being allocated to the C corporation blocker.

Obviously, from an LP's perspective, it will be less efficient to recognize gain in a domestic C corporation blocker than a REIT blocker.[14] By funding carried interest distributions through the sale of REIT assets, the LPs are disadvantaged. If, however, the situation was reversed, and REIT assets were sold first, the LPs could be advantaged by minimizing gain allocated to the C corporation blocker.

D. Stranding net operating losses (NOLs) in separate blocker corporations

As described in the first example above, if each property is held in a separate partnership, there is a material risk that early sales will result in the acceleration of gain to LPs, and later sales that fund catch-up and carried interest distributions could give rise to guaranteed payments for the GP and losses allocated to the LPs. If the LPs hold their interests in each of the separate partnerships through separate blocker corporations, the later losses will not offset the blocker-corporation taxes incurred in the earlier sales. On a single-partnership/single blocker-corporation basis, this result would not occur, as earlier asset sales could still produce allocations to the GP with respect to its carried interest. In addition, any subsequent losses that are not charged back to the GP to offset earlier carried interest allocations would be allocated to the same blocker corporation and might be carried back to offset earlier gains.

[14] For non-U.S. and section 892 foreign government investors, a sale of assets by the REIT could produce taxable gain under FIRPTA.

IV Other structural issues

Other structural issues also must be addressed when utilizing a fund structure with separate blocker entities and partnerships, a cumulative distribution waterfall, and crossed carry. Some of these issues are driven by the manner in which cash flow will be divided between the LPs and GP based upon the cumulative waterfall. Others are a product of the need to respect the separate nature of the entities in a context where the sponsor may intuitively think of the arrangement as representing a single investment platform.

A. Impact of overlapping waterfalls on repayment of blocker corporation debt

Often, a blocker corporation will be capitalized, in part, with debt advanced by non-U.S. or tax-exempt investors. The debt-equity and arm's-length pricing of the debt can be impacted by scenarios that might unfold in a structure where the carried interest is crossed among multiple partnerships utilizing a cumulative cash waterfall.

Consider the following example: $1,000 is invested in each of ten partnerships, $100 in each. With respect to each partnership, the LP investors advance $50 of capital and $50 of debt to a separate blocker corporation that contributes the capital to the partnership. The distribution waterfall provides for the return of LP contributed capital and a 10 percent IRR, with the GP then receiving 100 percent of distributable cash flow until it catches up to 20 percent of total distributions other than returns of contributed capital. Thereafter, cash flow is distributed 80–20 between the LPs and GP. In the fifth year, assume that five partnerships dispose of their assets for $1,500, so that the LPs' rights to return of all capital and the 10 percent IRR are satisfied. (Assume, for simplicity, no compounding.) In the sixth year, the sixth partnership sells its asset for $100. Under the distribution waterfall, this distribution would be made entirely to the GP under the catch-up tranche. Even though the property is sold for an amount equal to the invested capital, no amount would be paid to the LP-blocker corporation. As a result, no payment would be made on the investor debt owed by that blocker corporation.

As this example highlights, in a structure where the catch-up or carried interest distributions are crossed among multiple partnerships utilizing a cumulative cash waterfall, the repayment of blocker corporation debt may be dependent, not just upon the performance of the property that serves as collateral, but also on the timing of asset sales within the overall portfolio.

B. Accounting for movement of cash among investments within the overall structure

Another issue relates to the movement of cash among investments. Specifically, in many situations, certain assets will be cash-flow positive while others will require additional cash. Rather than call additional capital to fund the cash needs of the deficient investments, the choice often will be made to utilize the excess cash from the positive investments. If all assets are held under a single partnership, such cross funding should not raise any issues.

Note, however, that if the investments are held through separate partnerships and separate blocker corporations, the issues that arise from such cross funding become material. That is, each partnership and blocker corporation should be respected as a separate investor. Unrelated investors would not permit cash from one investment to fund the needs of an investment held by another investor without compensation for the use of the cash. The movement of the cash must be accounted for in some rational manner. The failure to rationally account for such cash arguably evidences a general lack of regard for the overall structure and could jeopardize the validity of the separate entities.

One manner of accounting for this movement of cash is to treat amounts paid by one partnership to another as distributed to the ultimate investor through the blocker corporation that holds the funding partnership, with the investor contributing such amounts to the relevant blocker corporation which then contributes such cash to the partnership in need of cash. If the first blocker corporation has earnings and profits, the distribution will be a dividend, and if non-U.S. investors are involved, the dividend could result in withholding tax at the blocker-corporation level.[15]

The other option would seem to be for the partnership with excess cash to lend an amount to the partnership that is in need of cash. In order to support the integrity of the overall structure, its seems that the loan should be made on arm's-length terms, charging a reasonable interest rate based on the risk relating to repayment, requiring repayment by some fixed date, etc.

C. Sale of blocker entities

Certain investors may prefer that the fund exit from an investment through the sale of the blocker entity that holds the property. In particular, non-U.S. and section 892 foreign government investors may desire that, for REIT qualifying assets, the fund sell stock of a REIT. If the REIT is "domestically controlled," these investors would be exempt from the tax generally imposed under the FIRPTA regime.

Given that fund economics, as between the LPs and GP, are determined by reference to cash realized by partnerships below the blocker entities, an exit through the sale of blocker entity stock can create material complications. Generally, the exit transaction would involve the sale of blocker entity stock by the LPs and the sale of a partnership interest by the GP.

If such a transaction is anticipated, the fund agreement governing the overall economics should anticipate the transaction and describe the results. Obviously, it will be difficult to separately negotiate the sale amounts for the GP and LPs with the purchaser, as amounts due under the waterfall may be dependent on the results and timing of other transactions being negotiated at the same time. Instead, a single purchase price generally would be negotiated, and the proceeds would be divided between the LPs and GP pursuant to terms in the fund agreement by reference to the overall waterfall.[16] Even though the cash received is the result of a sale of equity interests, the fund agreement would treat such amounts as distributed for purposes of determining future distributions under the waterfall.[17]

[15] Absent the use of loans, as described in the next paragraph, this is likely the transactional construct that would be deemed to occur under the tax rules in any event. Providing for such a construct in the transactional documents, however, seemingly would evidence a better recognition of the existence and substance of the separate entities.

[16] Any "haircut" in sales price due to the presence of the blocker entity seemingly would be borne proportionately by the parties, absent a provision in the fund agreement expressly addressing this issue.

[17] In addition to provisions governing the economics of such transactions, the fund agreement also generally would provide for coordination in the negotiation for sale of the separate equity interests, including forced sale or drag-along, tag-along rights.

The nature of the partnership interests acquired by the purchaser, in part directly and in part through the blocker entity, would seem to be a bit confusing. In the hands of the sellers, the interests are dynamic, with the economics dependent on events that occur in other partnerships. Once the purchaser acquires the interests, presumably the link to performance of other partnerships would be broken. It would seem that the current economics attributable to the GP's interest would be fixed by reference to the amount paid for the GP's interest. The economics relating to future appreciation or depreciation, however, seemingly would be undefined. A recapitalization of the interests in the hands of the purchaser would seem to be required.

Note that some unusual results may occur in a situation where the GP is entitled to a carried interest distribution under the waterfall and there is no gain inherent in the property. In general, a purchaser of a partnership interest steps into the shoes of the seller in determining the purchaser's capital account. It is arguable that a guaranteed payment should be triggered to the GP in advance of the sale to recognize the capital shift that entitles the GP to sales proceeds upon the disposition of its interest. In that scenario, the partnership would report ordinary income to the GP as a guaranteed payment equal to the sales proceeds that the GP will receive, and the GP would recognize no additional gain upon the disposition of its partnership interest.[18]

If this reporting is not followed, the purchaser presumably will acquire a partnership interest from the GP that has an embedded guaranteed payment right. This could create some concern for the buyer. The GP would recognize gain on the sale of its partnership interest. However, if the partnership had sold its property, no gain would be allocated to the GP upon the sale. Thus, even though the GP recognizes gain upon the sale of its interest, it appears that there would be no basis adjustment attributable to the interest purchased from the GP. Although a liquidating distribution attributable to the interest purchased from the GP might be characterized, in part, as a guaranteed payment, the relevant rules do not appear to provide for a basis adjustment to offset such an income inclusion. Presumably, the purchaser would not relish the prospect of receipt of ordinary guaranteed payment income upon a subsequent sale of partnership property offset at the partnership level by a loss that would be stranded in the blocker entity. The purchaser would have a high basis in the GP partnership interest, so presumably the purchaser would recognize a capital loss to match the guaranteed payment reported as ordinary income, but this character mismatch would be unattractive.

Issues relating to the ambiguity in economics and possible odd tax results may encourage a buyer to require the GP to contribute its partnership interest to the blocker entity in advance of the sale, so that the purchaser can simply acquire the blocker entity stock and fully understand the implications of its investment.[19]

More generally, these issues may raise questions as to the propriety of entering into a crossed carry structure if it is anticipated that a sale of entity interests may be a possible, or even common, manner of disposing of investments. A sale of blocker entity stock always carries with it additional issues to negotiate with a buyer, and the issues described above will only make those negotiations more complicated. In addition, the difficulty in rationally accounting for the tax and economic results of such a transaction in some situations may put a spotlight on technical weaknesses in the structure that could increase the risk associated with respecting the separate nature of the various entities.

D. Fractions rule compliance

Many real estate funds attempt to qualify under section 514(c)(9)(E) for the exemption from UBTI for debt-financed real estate investments. Two of the requirements for such qualification are that allocations must (1) have "substantial economic effect" and (2) satisfy the "fractions rule." Due to the flexibility required in making the allocations among the partners investing in separate partnerships with a cumulative waterfall and crossed carry, it generally will not be possible to satisfy either of these requirements. Thus, nongovernmental pension funds and educational institutions that desire to qualify under section 514(c)(9)(E) may not agree to participate in such a structure and may require a different parallel investment structure that could meet the qualification requirements.

[18] The blocker entity presumably would be allocated the deduction, and any NOL created would be subject to possible limitation under section 382 upon the change in control of the entity resulting from the sale.

[19] There also could be assignment of income or section 482 allocation of income issues for the GP in connection with transferring to a corporation a partnership interest that has an inherent right to a guaranteed payment immediately in anticipation of the sale transaction.


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Conclusion

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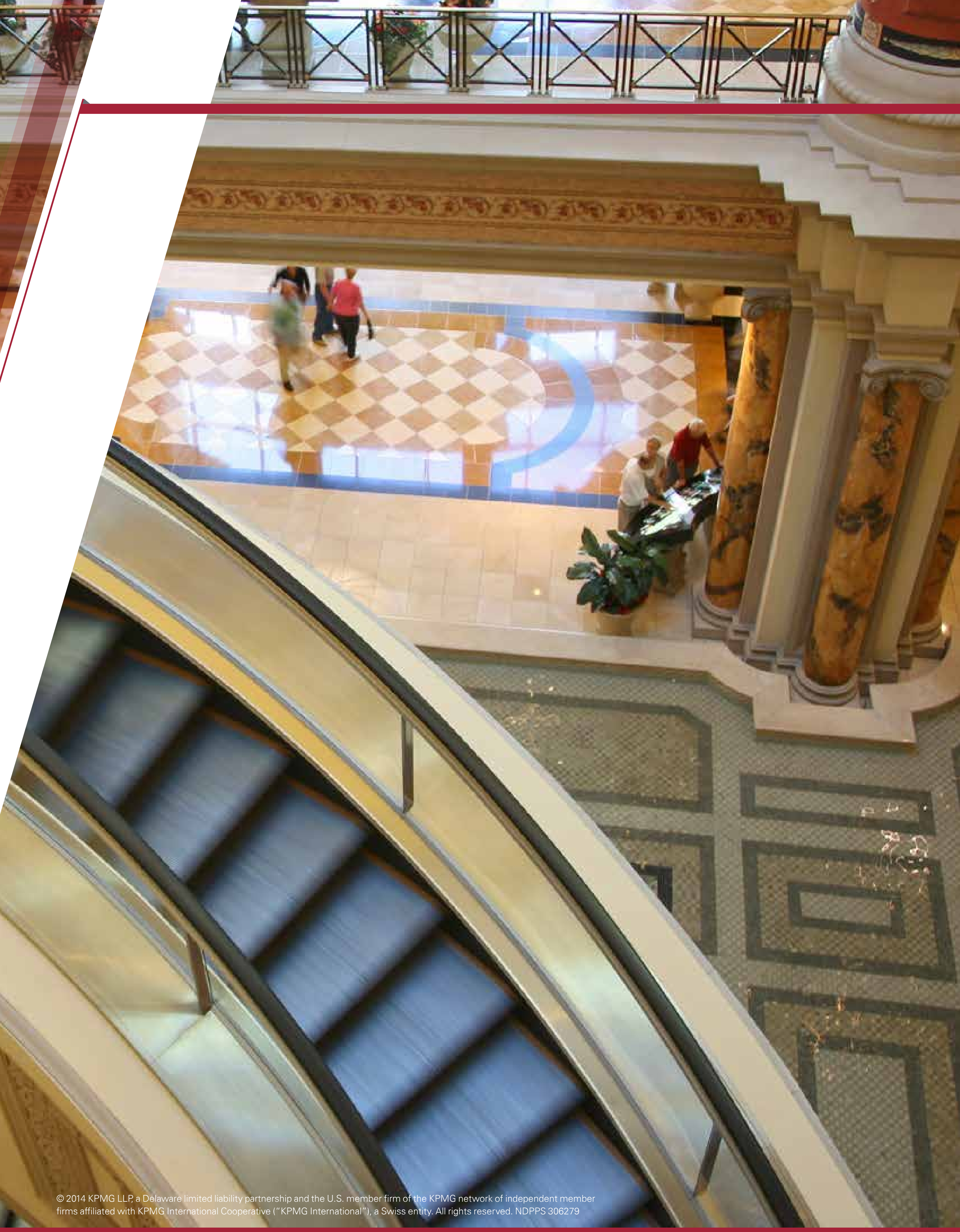
As the analysis above highlights, there are many factors to consider in determining whether to enter into a real estate fund structure that involves multiple partnerships and blocker entities, a cumulative distribution waterfall, and a crossed carry. Although the structure, if respected, may provide for a more efficient overall tax result by minimizing tax leakage created by blocker corporations, this will not always be the case. A number of factors, including the number of separate partnerships, the presence and materiality of a catch-up distribution, the order of asset sales, and the relative gain or loss recognized with respect to specific assets, will affect the ultimate determination as to whether the structure is more or less efficient on an overall basis. Often, it will be advisable to model different scenarios that could transpire so that the impact of the arrangement in those situations may be understood. In addition, the increased effort required to report such complex arrangements should not be underestimated.

As the saying goes, "there is no such thing as a free lunch." The saying is appropriate in this context: The decision by investors to utilize such a tailored structure is potentially detrimental to the sponsor due to the leakage created by the blocker entities, and it is perfectly understandable that the sponsor will implement structural adjustments to limit this detriment. Following from these dynamics, the decision for a sponsor to take its carried interest in separate partnerships underneath separate blocker corporations in order to avoid the inherent tax leakage seems, at first blush, to be simple and straightforward. In point of fact, however, such a decision is anything but simple and straightforward.



For more information, please contact:

Jim Sowell
T: 202-533-5710
E: jsowell@kpmg.com

Sarah Staudenraus
T: 202-533-4574
E: sarahstaudenraus@kpmg.com

Jim Tod
T: 559-840-2934
E: jtod@kpmg.com

kpmg.com