Cash and Carried Interests: Protecting the Investor and the Developer In a Real Estate Partnership[1]

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It is common for a real estate partnership to include one or more passive cash investors and a single real estate professional who will manage the venture. Usually, the form of the venture will be an entity taxable as a partnership; that is, a general partnership, a limited partnership, a limited liability partnership, or a limited liability company. For tax purposes, these entities are all the same (except to the extent some or all of the partners have or lack responsibility for the debts of the venture, which in turn will affect both allocations of entity-level tax items as well as apportionment of entity-level debt), and all are referred to as "partnerships" in what follows.

The operating agreement of a partnership can be simple or complex; if the partnership will incur debt, simple likely is not an option. The fact patterns discussed below are deliberately simple to highlight the basic structural elements involved when the developer is provided some form of extra proprietary return as compensation for managing the partnership's activity. There are nonproprietary ways to compensate the developer – any form of compensation that could be paid to a nonpartner for management activities can also be paid to a partner – but such techniques are not discussed here. In addition, the developer could be provided a compensatory option for the management services, and these as well are not discussed.

As a general rule, the requirement of "substantial economic effect" requires among other things that liquidation proceeds be distributed in accordance with final capital account balances. It is assumed in everything that follows that this requirement is satisfied. But it is worth mentioning that one now sees some partnership agreements drafted in other ways. In particular, cash flows might be defined with specificity and then tax allocations simply said to be in accordance with the partners' "interests in the partnership." Such a method of drafting ensures that a mistake in the tax allocation provisions does not affect any party's right to interim or liquidating distributions of cash, and in that regard offers a significant benefit. But the cost of such drafting is high: no roadmap is provided that informs the partnership (in actuality, the accountants hired by the partnership) how the entity's return is to be prepared or how the entity's tax items are to be shared among the members. It is, I think, a reasonable form of drafting for the nonexpert, but a better approach is to have the tax allocations drafted by someone confident in his or her ability to translate the economics of the transaction into appropriate allocation provisions and so permit the partners and their advisors to understand and anticipate the tax implications of the venture's activities.

- Kinds of Carried Interests

The term "carried interest" is not defined in the Internal Revenue Code or in the Income Tax Regulations. It is not, to the best of my knowledge, defined anywhere. It has come to stand for a partnership interest which is of secondary priority in terms of cash recovery; that is, it does not get paid first. Whether that means it gets paid last is something else entirely.

For example, suppose Investor contributes cash of $98,000 and Developer contributes cash of $2,000 to form the ID partnership. D is entitled to a 20% carried interest for services provided to the partnership after capital has been returned to the partners. Assume that ID puts its cash into two nondepreciable properties, Blackacre and Whiteacre, each costing $50,000.

> **Example 1:** Suppose Blackacre is sold by the partnership for $80,000 and the sale proceeds will be distributed to the partners. The cash of $80,000 can be seen two ways. First, it might be treated as a return of capital to the extent of $50,000 plus profit of $30,000 (an *asset-by-asset* approach). Second, it might be treated as entirely a return of capital because the partners' aggregate unreturned investment stands at $100,000 (an *aggregate* approach).
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> **Example 2:** Or suppose that Blackacre is sold not for $80,000 but rather for $130,000, and the partnership adopts the aggregate approach and so treats the proceeds as return of capital to the extent of $100,000 and profit of $30,000. Now that there are profits to be distributed, does the carry get 20% of taxable profit to date or 20% of available cash? These will be very different numbers, with the former effectively placing the carried interest after capital but in front of general profits.

- Taxation of Carried Interests

If partnership profit is determined on an asset-by-asset basis, the taxation of interim distributions works well. Note, however, that this assumes the partnership agreement does not include a preferred return (that is, a hurdle) in favor of the cash investor and computed on an aggregate basis. Assuming there is no such preferred return, profits can be allocated when and as distributed.

Consider first **example 1**. When Blackacre is sold for $80,000, there is a taxable gain to the partnership of $30,000. Under the terms of the partnership agreement, this should be allocated 20% (that is, $6,000) to D as the carried interest and the remainder between I and D in proportion to contributed capital (so that $23,520 is allocated to I and $480 is allocated to D). (This gives D an total interest in profits of 21.6% and I an interest in profits of 78.4%.) Assuming all the cash is then distributed, under the asset-by-asset approach it should go $49,000 to I and $1,000 to D as return of capital and then $23,520 to I and $6,480 to D as profit. The books of the partnership will then look like:

I		D		
Capital	Basis	Capital	Basis	
$ 98,000	$ 98,000	$ 2,000	$ 2,000	Contributions
23,520	23,520	6,480	6,480	Allocation of profit
(72,520)	(72,520)	(7,480)	(7,480)	Distributions
$ 49,000	$ 49,000	$ 1,000	$ 1,000	Totals

Suppose Whiteacre is then sold for $40,000. This represents a loss to the partnership of $10,000, and that loss should be charged back to the partners against the previously-allocated profits from Blackacre; that is, 78.4% to I and 21.6% to D. Using these numbers, the loss of $10,000 is allocated $7,840 to I and $2,160 to D. Putting these figures in the t-accounts yields:

I		D		
Capital	Basis	Capital	Basis	
$ 49,000	$ 49,000	$ 1,000	$ 1,000	Start
(7,840)	(7,840)	(2,160)	(2,160)	Allocation of loss
$ 41,160	$ 41,160	($ 1,160)	($ 1,160)[2]	Final capital

These final figures show that D must recontribute $1,160 to the partnership for distribution to I. That result makes sense: while the initial allocation of profit from the disposition of Blackacre was proper when done, in retrospect there was less over-all profit than anticipated. In fact, the partnership's investment of $100,000 was turned into $120,000, for a net profit of $20,000. Of that amount, D's share should be $4,000 for the carry plus 2% of $16,000 (or $320) as profit-share based on contributed capital, for an aggregate of $4,320. Thus, D should receive aggregate distributions of that amount plus D's contributed capital of $2,000, for a total of $6,320. Since D in fact was distributed $7,480 after the sale of Blackacre, D must be subject to a clawback of $7,480 less $6,320, or $1,160. And that is what the final capital account balance shows.

If the partnership treats all distributions as return of capital until capital has been fully returned, the timing of taxation will be skewed: in the early years, the owner of the carried interest will be forced to recognize income despite the absence of current distributions. This cash-flow difficulty can be addressed by providing for tax distributions, but tax distributions then require clawback provisions and proper crediting against general distributions of profit.

Reconsider **example 1** from an aggregate approach: the $80,000 proceeds from sale of Blackacre will be distributed entirely as a return of capital, which means $78,400 should go to I and $1,600 should go to D. But there is a taxable gain on the sale of $30,000 (sale price of $80,000 less cost basis of $50,000). How should that be allocated? Suppose we

[2] Of course, outside basis cannot be negative; rather, the excess loss is suspended. §704(d).

allocate that taxable gain as the cash is distributed; that is, 98% to I and 2% to D. If so, the books of the partnership become:

I		D		
Capital	Basis	Capital	Basis	
$ 98,000	$ 98,000	$ 2,000	$ 2,000	Contributions
29,400	29,400	600	600	Allocation of profit
(78,400)	(78,400)	(1,600)	(1,600)	Distributions
$ 49,000	$ 49,000	$ 1,000	$ 1,000	Totals

Suppose now that Whiteacre is sold for its cost basis of $50,000. There is therefore no book or tax gain, and the final capital accounts stand as shown above. There is $50,000 left to be distributed, and according to these final balances that cash should go $49,000 to I and $1,000 to D.

But that cannot be right: the partnership turned an aggregate profit of $30,000, yet somehow D gets only its original capital back plus $600. What happened to the 20% carry? Perhaps the partners should agree to distribute the final cash other than in accordance with final capital account balances, but that violates the requirement of economic effect imposed by the section 704(b) regulations. Would a clawback work, this time imposed on I?

No. If we require that I contribute additional funds to the venture, that contribution will increase I's capital account. And because final liquidation proceeds must be made in accordance with capital account balances, the clawback cannot operate to shift funds from I to D. The only way that D can come out right is if the problem is anticipated and addressed in tax allocations from the beginning.

Go back to the year in which Blackacre is sold for a gain of $30,000. If that gain is allocated in accordance with each partner's interest in profits (including the carry), then the capital accounts will work out properly. Thus, putting that allocation into the books of the partnership *and again distributing cash as a return of capital*, we get

I		D		
Capital	Basis	Capital	Basis	
$ 98,000	$ 98,000	$ 2,000	$ 2,000	Contributions
23,520	23,520	6,480	6,480	Allocation of profit
(78,400)	(78,400)	(1,600)	(1,600)	Distributions
$ 43,120	$ 43,120	$ 6,880	$ 6,880	Totals

If Whiteacre is now sold for its cost of $50,000 and the partnership liquidates, its cash will be distributed in accordance with the final capital accounts balances shown above; that is, $43,120 to I and $6,880 to D. D's share of the profits was supposed to by 20% off the top plus 2% of the remainder, or $6,000 plus $480. Since D should recover over the life of the venture that amount plus D's contributed capital of $2,000, D should receive a total of $8,480. In fact, D received an interim distribution of $1,600 plus a liquidating distribution of $6,880, for the proper total of $8,480. Thus, the lesson from this is that even if cash will be distributed on an aggregate basis, *profits must be allocated asset-by-asset*.

Which causes a cash-flow problem for D because in the early years D must be *allocated* a share of taxable income based on D's profit interest while cash will be *distributed* in proportion to contributed capital. If D can handle the current tax liability without a covering distribution, no problem is raised. Often, though, D requires an interim distribution of cash sufficient to cover the tax liability. Such a distribution causes no tax problem but can result in a net excess distribution to D and so must be accompanied by a clawback obligation if the economics of the partners' economic arrangement is to be maintained.

For example, when Blackacre is sold for $80,000, D's share of the $30,000 taxable gain is $6,480. It is impossible to determine D's tax liability resulting from the allocation without knowing D's other items of income and deduction and, in fact, it is difficult even to define that portion of D's aggregate tax liability attributable to the partnership allocation even if all the facts are known. (For one early attempt to solve this problem, see the facts of *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929).) As a result, the tax distribution to D usually is defined not by reference to any actual tax computation but rather by making certain arbitrary assumptions that should approximate whatever tax liability to D actually results. For example, the partnership agreement might specify that D's tax distribution will equal 40% of D's income allocation. In reality, though, even a relatively wooden tax distribution should be considerably more nuanced by taking into account state and local taxes, changes in tax rates, prior losses, and similar items.

But to make the important point, a 40% tax distribution works fine. So, if D's allocable share of gain from the sale of Blackacre equals $6,480, then the tax distribution should equal $2,592. Since without a tax distribution D would be entitled to receive only $1,600, this represents what amounts to an advance of $992. Note that D should not be entitled to both the tax distribution and the interim distribution based on share of contributed capital. Rather, the tax distribution should be charged against the cash to which D is otherwise entitled.

If Whiteacre is then sold for its cost of $50,000, everything works out fine, as the books become:

I		D		
Capital	Basis	Capital	Basis	
$ 98,000	$ 98,000	$ 2,000	$ 2,000	Contributions
23,520	23,520	6,480	6,480	Allocation of profit
(77,408)	(77,408)	(2,592)	(2,592)	Distributions
$ 44,112	$ 44,112	$ 5,888	$ 5,888	Totals

If D now receives a liquidating distribution of $5,888, D will again have received distributions aggregating $8,480, precisely the amount of D's contributed capital plus share of profits.

But what if Whiteacre had instead been sold at a loss of $30,000; that is, what if it had been sold for only $20,000. The loss should be charged back to the partners as they shared the prior allocation of income, but that causes D's capital account to be driven negative:

I Capital	I Basis	D Capital	D Basis	
$ 98,000	$ 98,000	$ 2,000	$ 2,000	Contributions
23,520	23,520	6,480	6,480	Allocation of profit
(77,408)	(77,408)	(2,592)	(2,592)	Distributions
(23,520)	(23,520)	(6,480)	(6,480)	Allocation of loss
$ 20,592	$ 20,592	($ 592)	($ 592)	Totals

As these final capital account balances show, D should now be required to recontribute $592 to the partnership for distribution to I. This result makes sense: in the aggregate, the venture just broke even, so neither partner should make a net profit or loss. Because the interim tax distribution to D exceeded D's contributed capital, D should be required to return that excess.

But D will not want to return that $592, and with good reason: D has not ever enjoyed it. Rather, it was paid (along with the other $2,000 received as an interim tax distribution) to the government as an income tax payment. D will ask why he, rather than I, should bear this tax cost of the venture. Assuming the loss is capital, if D is a corporation, there is the possibility of a loss carryback, an immediate refund, and full repayment to the partnership. But if D is an individual, the capital loss can only be carried forward with no guarantee that it will ever offset income.

Surprisingly, this issue does not disappear if property is distributed in-kind. To be sure, the in-kind distribution will not, in general, trigger the recognition of gain and so does not give rise to any immediate imposition of tax. But at some point the distributee will sell that property, and a tax liability will have to be funded. Presumably the value of distribution itself can give rise to a potential clawback obligation; whether that obligation should be reduced by the future tax liability is something the partners must face when the clawback provision is drafted.

Finally, another alternative is to make a tax distribution to each partner, with any excess treated as a return of capital. After the sale of Blackacre, this puts much less cash in the hands of the D, yielding:

I Capital	I Basis	D Capital	D Basis	
$ 98,000	$ 98,000	$ 2,000	$ 2,000	Contributions
23,520	23,520	6,480	6,480	Allocation of profit
(9,408)	(9,408)	(2,592)	(2,592)	Tax distributions
(66,640)	(66,640)	(1,360)	(1,360)	Return of capital
$ 45,472	$ 45,472	$ 4,528	$ 4,528	Totals

If the partnership does even better from the sale of Blackacre, yet another problem arises. Consider the facts of **example 2** in which Blackacre is sold for $130,000; that is, at a gain of $80,000. Ignore for a moment the possibility of a tax distribution, and consider only how the cash in excess of capital should be distributed; that is, how the last $30,000 should go as between I and D (the first $100,000 should be distributed $98,000 to I and $2,000 to D as a return of capital).

D's total share of the profit is 21.6% of $80,000; that is $17,280. Of that amount, $16,000 is attributable to the carried interest and 2% is attributable to D's share of contributed capital. If cash in excess of return of capital is distributed in accordance with overall profit interests, then D will receive 21.6% of $30,000, or $6,480, leaving $23,520 for I. But if the carried interest is in effect a substitute form of compensation for services provided to the partnership, perhaps it should be distributed prior to other distributions of profit. That is, of the available $30,000, perhaps $16,000 should be distributed to D and the remaining $14,000 should be distributed between I and D in the proportions 98% to I and 2% to D.

Indeed, now add the requirement of tax distributions to the mix. The partnership's taxable gain of $80,000 is allocated $62,720 to I and $17,280 to D. Those allocations result in tax distributions of $25,088 for I and $6,912 for D. If these tax distributions are made, it leaves only $94,000 available as a return of capital. As a result, there is no pocketable cash for D beyond D's return of capital ($1,880) even though D has a 20% carry and the partnership did spectacularly well on its investment in Blackacre.

- Hurdles

Often, D's carried interest is conditional on the partnership achieving certain financial results; unless these results are realized, the carried interest is reduced or eliminated. For example, the carried interest might not apply except to the extent that the partnership achieves a return on investment of more than 6%. Such a financial hurdle can be implemented in a variety of ways.

The partnership might provide that a guaranteed payment will be made on contributed capital, either on all contributed capital or on that of I alone. Because a guaranteed payment for the use of capital is deductible to the partnership, the effect of such a guaranteed payment obligation is to reduce the partnership's net income. And because D's carried interest is a percentage of income, that means that the guaranteed payment eliminates D's carry on the income used to satisfy the guaranteed payment obligation. Note that while these examples assume the guaranteed payment is made out of disposition proceeds, operating cash flow also could be used.

The guaranteed payment obligation can be cumulative or noncumulative, with cumulative being the most common. For example, return to the facts of **example 1**, and assume that the partnership agreement guarantees I a cumulative return of 6% (compounded annually) on I's invested capital. Add to the facts that Blackacre is sold exactly two years after the partnership is formed. That means that in the year Blackacre is sold, the partnership's income will not be $30,000 but only $17,887 because of the deduction for the guaranteed payment of $12,113. Thus, the books of the partnership will become:

I		D		
Capital	Basis	Capital	Basis	
$ 98,000	$ 98,000	$ 2,000	$ 2,000	Contributions
14,023	14,023	3,864	3,864	Allocation of profit
(5,609)	(5,609)	(1,546)	(1,546)	Tax distributions
(59,517)	(59,517)	(1,215)	(1,215)	Return of capital
$ 46,897	$ 46,897	$ 3,103	$ 3,103	Totals

These books assume that each partner is entitled to a tax distribution equal to 40% of allocated profits, that capital is returned to each partner in proportion to contributions before the carried interest is distributed, and that the deduction arising from the guaranteed payment is offset against the partnership's income rather than specially allocated in some other way. Note that the guaranteed payment to I reduced both the amount of cash distributed to D as well as the amount of income allocated to D. As a result, it reduced both the amount of cash D receives in the current year and in the aggregate.

If Blackacre had been sold for its initial cost of $50,000, then the guaranteed payment obligation would have to be funded out of the partners' equity. The guaranteed payment to I again equals $12,113, so the partnership has a net loss for the year in that amount. Allocating that loss in proportion to contributed capital produces:

I		D		
Capital	Basis	Capital	Basis	
$ 98,000	$ 98,000	$ 2,000	$ 2,000	Contributions
(11,871)	(11,871)	(242)	(242)	
(37,129)	(37,129)	(758)	(758)	Return of capital
$ 49,000	$ 49,000	$ 1,000	$ 1,000	Totals

Note that if Whiteacre subsequently is sold at a gain, that gain will first be allocated 98% to I and 2% to D to the extent of the first $12,113; gain in excess of that amount will be allocated 78.4% to I and 21.6% to D. Of course, the guaranteed payment obligation arising at that time will affect the computation of gain.

An alternative to a guaranteed return for the use of capital is a preferred return to I. In many ways, a preferred return and a guaranteed payment are the same. But there are two significant differences: (1) if the partnership does not do well, the preferred return will have no impact while a guaranteed payment obligation must still be satisfied; and (2) the guaranteed payment is taxed as ordinary income to the recipient and generates an ordinary deduction for the partnership (usually shared between I and D) while a preferred return does not affect the character of income or loss.

Return to the facts of **example 1**, and assume that I is entitled to a preferred return equal to 6% of invested capital, compounded annually. If Blackacre is sold exactly two years after the partnership is formed, then the first $12,113 of taxable gain is allocated entirely to I; the remainder of the $30,000 gain (that is, $17,887) is then allocated by reference to I's carry followed by an 80/20 split. The books of the partnership thus become:

I Capital	I Basis	D Capital	D Basis	
$ 98,000	$ 98,000	$ 2,000	$ 2,000	Contributions
12,113	12,113	0	0	Preferred return
14,023	14,023	3,864	3,864	Allocation of profit
(12,113)	(12,113)	0	0	Preferred dist.
(5,609)	(5,609)	(1,546)	(1,546)	Tax distributions
(59,517)	(59,517)	(1,215)	(1,215)	Return of capital
$ 46,897	$ 46,897	$ 3,103	$ 2,933	Totals

Note that the ending values here correspond to the same values in the first guaranteed payment example above. In this example, the preferred return represents an allocation of profit *to I* and therefore an allocation *away from D*; coupled with an equivalent distribution of cash (tax-free under section 731), this is *in effect* the same as a deduction *to the partnership* and a taxable distribution *to I.*

A final way to ensure that I gets a sufficient return on his investment prior to D receiving the carried interest is to subject the carried interest to a vesting schedule. For example, the carried interest might start at 0 and then increase by 4% per year until its reaches its maximum value of 20% after the fifth year of the partnership. While subjecting D's carried interest to a vesting schedule does not guarantee any specific return to I, it does ensure that if the venture does not work out as anticipated and I is forced the terminate the venture prematurely, I will not be entitled to a relatively large portion of the profits despite performing a relatively small effort. Note that a vesting schedule can be coupled with a guaranteed payment or preferred return to I, and that vesting could be accelerated if I terminates the venture without cause (as specified in the partnership agreement).

Using a vesting schedule requires that the partnership compute a *target capital account* for D each year and then allocate partnership tax items until that target is reached. For example, suppose the partnership has $100,000 in a year in which's interest in the venture equals 2% (based exclusively on contributed capital) and an equivalent amount of income in the following year when D's interest is increased to a 4% carry plus 2% of the remaining 96% (for a total profit share of 5.92%). If, after the second year D's capital account should be increased by 5.92% of aggregate profits, then D's share of the second year profits must equal 9.84%.

On the facts provided above, D's target capital account after two years equals $13,840, where that is D's contributed capital of $2,000 plus 5.92% of the partnership's $200,000 aggregate profit. After the first year, D's capital account equals $4,000, composed of D's contributed capital of $2,000 and D's $2,000 share of first-years profits. As a result, to get D to where D belong as year two, D must be allocated partnership income of $13,840 less $4,000, which is $9,840 (or 9.84% of year two's $100,000 of income).

If distributions are made while the carried interest is vesting, then the D's actual account be grossed-up by those distributions when compared to D's target capital account so ensure that D does not receive more than D's proper share. For example, suppose on the facts above that D had received a distribution in year one of $800. That would make D's actual capital account after year on only $3,200, and if this value were compared with D's target capital account of $13,840, it would suggest D is entitled to an allocation in year two of $10,640. But that is not right: the prior distribution should have no effect on D's allocable share of partnership profit.

- Tax Consequences of the Contribution of Property to a Partnership

If property is contributed in-kind to the partnership, a host of additional issues arise. First, under section 704(c)(1)(A), allocations of tax items attributable to the contributed property must take account of the variation between the adjusted basis of the property (carried over from the contributing partner) and the initial book value of the property (equal to the property's fair market value as of the date of contribution of the property to the partnership). Much has been written on these issues. *See, e.g.*, Howard E. Abrams, *Dealing With the Contribution of Property to a Partnership: Part I*, BUSINESS ENTITIES 16 (November-December 2000); Howard E. Abrams, *Dealing With the Contribution of Property to a Partnership: Part II*, BUSINESS ENTITIES 18 (January-February 2001).

If the property is contributed in-kind by a non-managing partner, the contributing partner might seek some protection from the rule that any *built-in gain* in the contributed property must be allocated to (and so includible by) the contributing partner when the property is sold. In addition, if the contributed property is distributed to another partner within seven years of its contribution to the partnership, that gain again must be allocated to the contributing partner. While these rules cannot be varied by agreement between the partners, the partners might agree that the contributed property will not be sold or distributed for some specified period of time. In the alternative, the partnership might have the right to deal with the property as it chooses so long as some compensation is provided to the contributing partner who will bear the tax burden of the partnership's actions.

One point that is easy to overlook is that the contributing partner must be careful to prohibit the contribution of the contributed property to a lower-tier partnership. While that transaction will not of itself trigger any gain, once the property is held by the lower-tier partnership, any contractual restrictions imposed on the upper-tier partnership lose their efficacy because, without careful drafting, these restrictions will not apply to the lower-tier partnership.

For example, suppose the Investor contributes substantially appreciated but unimproved real estate to the partnership. The partnership agreement provides that the Developer may not dispose of the contributed property in a taxable transaction for the first five years of the venture. Further, the agreement provides that if the contributed property is transferred in a tax-free transaction, the property received in exchange will continue to be subject to the five year restriction.

This provision works fine for a possible like-kind exchange: there is no reason to prohibit such an exchange so long as the replacement property is not itself sold prematurely. But if the contributed property is transferred to a new partnership in exchange for an interest in that new partnership, the contributing partner faces adverse tax consequences if *either* the interest in the lower-tier partnership is sold *or* the property itself is sold by the lower-tier partnership. Note also that a distribution of the contributed property to the Developer is tax-free to the partnership and so not prohibited by the sample clause described above yet this transaction is again tax adverse to the contributing partner (that is, to Investor).