REAL ESTATE VENTURES: BRIDGE EQUITY

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INTRODUCTION

Often, if not usually, the acquisition of real estate by a joint venture is funded in part by third-party debt financing and in part by equity contributions. But what happens if the third-party debt is not ready to close in time for the acquisition? The parties may not have finished negotiating the loan documents, or the third-party lender may not have completed its underwriting. In some economic climates, the third-party financing source may not even have been located, let alone committed to closing. In such circumstances, the parties often look to the equity providers as an alternative source of bridge funds for the acquisition. Given the variety of ways a joint venture can be structured, we will make the following assumptions to frame this discussion:

Potential Venture

An institutional real estate opportunity fund (the investor) and a local operator or developer (the sponsor) are negotiating an agreement to form a Delaware limited liability company to acquire and develop real estate.

Venture Terms

It was anticipated that the acquisition and other project costs would be funded by a combination of equity and debt financing, with 65 percent of the costs financed by third-party debt and the remaining costs funded by equity contributions, with the investor responsible for 90 percent of the capital contributions and the sponsor responsible for the remaining 10 percent. The joint venture will make distributions to the investor/sponsor 90/10 until the investor achieves a 12 percent internal rate of return (IRR), and then 70/30. Given the level of investment by the investor, it will have substantial control over the decisions of the joint venture and, in particular, a veto right over any financing. Additionally, the venture will be taxed as a partnership.

Real Estate Contract

The sponsor has already entered into a contract to purchase the real estate, and a substantial deposit will become non-refundable in a few weeks. Upon forming the venture, the purchase contract will be assigned to the venture in order to consummate the closing.

Third-Party Financing

The anticipated third-party debt for the acquisition costs is not available on the anticipated closing timeline, and the only short-term third-party funding the sponsor has been able to locate is prohibitively expensive. The sponsor is confident (and the investor concurs) that third-party financing will ultimately be available because of the anticipated success of the project. However, the sponsor wants the investor to step in to fund the entire 65 percent of the acquisition costs that would have been financed by third-party debt because the sponsor does not have capital available to fund more than its 10 percent share of the originally anticipated capital contributions to the venture.

Investment Limitations

The amount of the investor's investment in the venture (after taking into account the equity contributions and bridge funds that will be provided by the investor) will not exceed any maximum investment limitations (by size or concentration) contained in the investor's fund documents.

This article will discuss some of the concerns to be considered by the investor and the sponsor in determining whether and how to structure this gap investment.

ALTERNATIVE STRUCTURES

There are typically two main alternatives for the investor to bridge the gap that would otherwise be filled with the contemplated third-party financing: (i) a bridge loan made by the investor or an affiliate to the venture; or (ii) bridge equity contributed by the investor to the venture. In deciding which alternative to choose, the considerations to evaluate include the following:

Identity of Lender

In evaluating whether a bridge loan is preferred over bridge equity, one important consideration is the identity of the lender. Sometimes an investor will have an affiliated lender who is already in the business of real estate lending. However, if that is not the case, the investor may need to consider whether it can make the bridge loan itself or establish a new lending entity without having to register as a lender or satisfy other regulatory hurdles depending on the jurisdiction.[1]

Collateral

An attractive feature of the bridge loan weighing in favor of selecting bridge debt over bridge equity is the fact that debt may be secured by a mortgage or deed of trust, or a pledge of the investor's and sponsor's respective ownership interests in the venture, providing collateral security and insurable priority. However, this same feature can weigh against the bridge loan because it tends to add layers of complexity to the business deal which will be time consuming and costly to resolve.

Time and Cost

In contrast to bridge equity, which will often be documented within the venture agreement, a bridge loan typically requires negotiation of a separate set of loan documents and security instruments, resulting in higher legal costs for the time-consuming negotiations. Even if a bridge loan is unsecured, there are still questions regarding documentation (e.g., will there be a promissory note?), usury, and the like. Additionally, the parties will need to allocate responsibility for the additional cost of the lender's separate legal costs, the lender's title policy[2] (in the case of a mortgage or deed of trust) or Uniform Commercial Code (UCC) insurance policy (in the case of a pledge of the investor's and sponsor's respective ownership interests in the venture) and any applicable mortgage or similar tax (e.g., as in Florida[3]). Determining who will cover these additional costs will be yet another term to work through in an already stressed business deal.

Other Issues

- *Credit Enhancement*: Whether the investor lender will require a non-recourse carve-out guaranty, an environmental indemnity, or other credit enhancement, and if so, whether the sponsor will be willing to provide such credit enhancement;
- *Title Insurance*: Whether the investor lender will require title insurance with a non-imputation endorsement (precluding imputation of the sponsor's or the venture's knowledge to the investor lender) if the bridge loan will be secured by a mortgage or deed of trust;
- *UCC Insurance*: Whether the investor lender will require UCC insurance with endorsements for pledged equity, seller's liens, tax liens and waiver of subrogation if the bridge loan will be secured by a pledge of ownership interests in the venture; and
- *Enforcement Risks*: Whether there will be challenges to enforcement. For example, does the enforcement of a bridge equity loan create a conflict of interest that is irreconcilable with the lending member's fiduciary duty of loyalty and consequently preclude or limit the anticipated rights of the lending member. As famously stated by Justice Cordozo:

> Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties.[4]

However, loans by a member of a limited liability company are authorized by statute in Delaware and some other states.[5] And in some jurisdictions, fiduciary duties may be waived.[6] A second example might be a recharacterization of the loan to equity, especially if the limited liability company declares bankruptcy.[7]A third example might be equitable subordination.[8] Finally, if the loan is secured by the real estate owned by the limited liability company, then there may be multiple and potentially conflicting laws and venues for disputes (the venture may be governed by Delaware law but the loan will be governed, at least in part, by the laws of the jurisdiction where the real property collateral is located).

At the end of the day, the very things that may make a loan more attractive (e.g., being able to have a mortgage or deed of trust or pledge of ownership interests to secure repayment) may also be the very things that push the parties toward a bridge equity approach (due to the additional layers of risk, liability and cost).

Simplicity[9]

By far the most compelling feature of utilizing bridge equity over bridge debt is the simplicity of implementation, which tends to reduce the ancillary cost of implementing this approach to cover the financing gap.

As noted above, a bridge loan may trigger a number of documentation challenges that are not present in the context of bridge equity. By contrast, bridge equity will be factored into the joint venture documentation, which already addresses the complexities of funding and distribution mechanics, and the allocation of risk, liability, and control. The main additional provisions in the venture agreement will largely involve the rate of return for the bridge equity and the priority of distributions for repayment. If the bridge equity were contributed as common equity, the investor would face a potentially greater risk but also a chance for higher returns (and the sponsor might complain that there should be a lower unlevered rate of return). As such, sponsors generally prefer that bridge equity be contributed as preferred equity with a lower rate of return than the common equity (and we will assume that the bridge equity is so structured), at least at the outset.

Tax Issues

Tax issues should also be considered in deciding whether to implement a bridge debt strategy or to utilize bridge equity to cover the financing gap. While parties generally focus on the economic and liability risks of a particular approach, the tax implications may often be a determining factor. Given the complexities of such considerations, our discussion of the tax implications and considerations of the two different alternatives is set forth in the attached Appendix.[10]

Ultimate Determination

While there may be circumstances when an investor bridge loan will be the chosen approach (e.g., (i) when the investor is a tax-exempt entity without a REIT blocker, and it is anticipated that some of the preferred equity would remain in place after financing is obtained;[11] or (ii) when an affiliate of the investor is in the business of making loans), in the authors' experience the more common outcome will be investor-provided bridge equity. Therefore, the balance of this article will assume that a bridge equity approach has been selected.

THE COST TO THE VENTURE (AND SPONSOR)

The rate of return for bridge equity often ties to the source of the investor's funds.

Investor's Subscription Line Rate

While the rates for subscription lines may be more favorable than other sources of funds, subscription credit facilities (or the terms of the investor's fund documents) may contain a limit on how long loan advances under the facility may be outstanding and may not be intended for bridge equity.

Loan Rate

The investor is usually not in the business of making loans, and its investors may expect higher returns. Moreover, third-party preferred equity is typically much more expensive than mortgage debt or mezzanine debt.

Hurdle Rate

Although the sponsor may want the return on bridge equity to be less than the return on common equity, the investor may expect that the bridge equity rate will not be less than the lowest hurdle rate on contributions of common equity.

DURATION

Bridge equity is often, if not usually, intended to be in place for a brief period, such as 30 or 90 days.

Consequences of Exceeding Term

If things do not go as planned, the bridge equity may remain in place longer than anticipated. In that event, the investor will want to have negotiated for an "out" such as:

- *Converting to Common Equity*. One possibility would be to convert the preferred bridge equity to common equity (and dilute the sponsor's 10 percent equity interest accordingly).[12] But the sponsor may not want to do this unless the returns for common equity are lowered to reflect market unlevered rates. The investor may also not want to invest so much in this particular deal (and might want, for example, a bonus/penalty in connection with the dilution to compensate it for the additional investment it did not plan to make). Also, the venture percentages will be out of sync with outstanding capital and accrued return because of the accrued return on the bridge equity.[13] Finally, if none of the preferred equity has been repaid, then the sponsor's 10 percent equity interest would be reduced to 3.5 percent (i.e., 10 percent of 35 percent) and this might trigger discussion of some of the other provisions in the venture agreement (e.g., control).
- *Retaining the Preferred Equity*. The members may instead prefer to keep the preferred equity in place. But this may not be acceptable to the investor, who is likely not in the business of funding preferred equity, especially when it is not getting market preferred equity rates of return.
- *Right to Cause a Sale or Refinancing*. The investor may want its bridge equity repaid and, to that end, might want to unilaterally trigger a sale or refinancing of the venture's assets.
- *Right to Syndicate or Bring in Additional Investor*. Another way to get the investor's bridge equity repaid would be to bring in additional investors. But this might be more expensive money.

Risk of Inertia (How to Find the Right Push and Pull)

Finding the right bridge equity terms is important. If the bridge equity terms are too good for the investor, what is to stop it from vetoing any financing to take out its bridge equity? And if bridge equity terms are too good for the sponsor, what is to stop it from not seeking replacement financing?

SHORTFALL

Even if third-party financing is ultimately obtained, what if it is not sufficient to completely take out the bridge equity? Some of the same solutions discussed above (e.g., converting to common equity, or retaining the remaining preferred equity) would also be options in that situation. If the remaining amount is small enough, the associated issues discussed earlier may be easier to resolve.

CONCLUSION

In any joint venture acquisition, there may be a lot of balls in the air as the parties prepare for closing, such as complying with the terms of the purchase agreement for the real estate, establishing the terms of any contemplated development and construction (including obtaining any needed contractors and locking in pricing so that costs can be reliably budgeted), securing and establishing the terms of the third-party financing needed for the acquisition and any development and construction, and negotiating the terms of the joint venture itself. Unfortunately, things do not always go as planned. If the third-party debt financing does not fall into place on a timely basis, then the venture must quickly decide whether and how to proceed. Bridge funding may be a solution, but it requires careful thought and planning that may be challenging at the last minute. Having thought through some of the relevant considerations in advance may help find the right solution when this problem arises.

APPENDIX A

BRIDGE EQUITY - TAX CONSIDERATIONS

This Appendix will briefly discuss some of the tax considerations to take into account in determining whether to structure the investors' funding of a bridge replacement of third-party financing as debt or equity.

INTRODUCTION

Income and other taxes may also play a part in deciding whether to proceed with bridge debt or bridge equity. The most obvious issues associated with the choice of debt or equity relate to the treatment of interest payments for a bridge loan, on the one hand, and the treatment of preferred return payments for bridge equity that is structured as preferred equity, on the other hand. We will briefly discuss those tax issues and a few others.

The discussion below is limited to the circumstance where the venture is operated through an entity classified as a partnership for federal income tax purposes. The tax treatment of equity and debt investments in entities with other income tax classifications, including entities taxed as corporations, involves additional and different considerations than those addressed herein.

The summary below is not a comprehensive discussion of the tax considerations involved in deciding between structuring bridge funding as debt or equity, and investors should consult with their tax advisors regarding their individual circumstances and characteristics, which may affect the considerations discussed in this Appendix. Investors that are not United States persons for purposes of the United States Internal Revenue Code, for example, have specific rules that apply to them depending on whether an investment in a United States venture is structured as debt or equity.

INTEREST PAYMENTS

In the bridge loan scenario, if the loan is respected as debt, and there are no limitations on the deduction of interest applicable to the venture, then: (i) the interest payments should be deducted by the venture;[14] and (ii) the interest payments should give rise to ordinary income to the lender.[15]

There are also specific provisions that apply to such "self-charged interest" (i.e., interest the investor-lender is charging itself to the extent it has an ownership interest in the venture-borrower) under the passive activity loss rules.[16] Generally, if the activities being conducted by the partnership are considered to be passive with respect to the member (likely to be the case for the investor but not the sponsor), the interest income received may be recharacterized as passive activity income rather than portfolio income. However, this result may be preferable to an investor to ensure that the interest income is able to be offset by losses being passed through by the venture. In addition, these special rules provide flexibility to taxpayers in that an election out is made available at the partnership level.[17] The optionality afforded by the passive activity loss self-charged interest rules in taking into account self-charged interest income thus may be an attractive feature to an investor. Other tax issues associated with interest in the debt scenario, including potential limitations on interest deductions, are beyond the scope of this article.

PREFERRED RETURN PAYMENTS

By contrast, the tax treatment of preferred return payments is generally more straightforward. If such payments must be made regardless of the venture cash available for distribution (or in the words of the Internal

Revenue Code, if they are "determined without regard to the income of the partnership"), then they may be treated as guaranteed payments.[18] Such payments would be ordinary income to the investor.[19] And they would be deductible by the venture[20] unless they fail to meet the "ordinary or necessary business expense" test, in which latter event they are capitalized.[21] Specifically, guaranteed payments for the use of capital are treated as equivalent to interest for purposes of the uniform capitalization rules for direct and indirect costs of construction of certain property, including real property.[22] Thus, if the bridge equity capital is used to construct a building, a preferred return payment that is a guaranteed payment may be required to be capitalized as part of the building's cost rather than being immediately deducted as an expense.[23] However, if the preferred return is payable only to the extent cash flow is available, then these issues will not arise.

TAX BASIS

In the equity scenario, the contribution of bridge equity gives rise to additional basis in an equal amount.[24] Although a loan to the venture generally increases a member's basis only by the amount of such member's increased share of liabilities, a loan from a member or affiliate is generally allocated 100 percent to that member.[25] Consequently, there are not likely to be basis issues as a result of choosing one rather than the other alternative.

REITS

There may be additional tax considerations if the bridge debt investment is made through a real estate investment trust (REIT), including where the lending investor is a pass through entity for federal income tax to an upper tier REIT.[26] A loan can be a risky investment for a REIT depending on whether it qualifies for the 75-percent-asset test[27] and whether it causes a violation of the limits for holding certain securities.[28] Only certain types of loans are treated as "real estate assets" for purposes of the real estate investment trust qualification rules. The investor's loan should generally be treated as a good asset to the extent it is secured by a mortgage on the venture's real property.[29] It may also be a real estate asset if it is secured by an ownership interest in the venture.[30] It may also be treated as a real estate asset if it relates to temporary investment of new capital received by the REIT up to one year following the REIT receiving such new capital.[31] These issues go away if equity is chosen instead of debt.

TAX EXEMPTS

There may be additional tax considerations if, somewhere in the chain of ownership, there is a tax-exempt entity that is subject to unrelated business income tax.[32] Tax-exempt entities that own an interest in an entity taxed as a partnership that incurs debt to acquire or improve property may be subject to tax on resulting income under the "debt financed property rules."[33] Debt-financed property may give rise to tax on roughly the portion of the investment that is financed;[34] the relevant financing used to acquire debt financed property is called acquisition indebtedness.[35] Certain specific types of tax-exempt entities referred to as qualified organizations, however, are not subject to the debt-financed income rules on investments in real property, provided that the investment also satisfies certain additional tests, including potentially the fractions rule, when made through an entity taxed as a partnership.[36] In the bridge equity scenario, a preferred equity investment could give rise to a violation of the fractions rule, although there are also certain exceptions that may be available with respect to preferred returns or guaranteed payments that are found to be reasonable.[37] Alternatively, acquisition indebtedness problems may be avoided if the tax exempt entity makes its equity investment through an entity (a so-called blocker), such as a REIT, that is not subject to UBTI (or similar issues) resulting from acquisition indebtedness.[38]

PROBLEM DEALS

If the deal goes south, and the venture fails to get the full amount of anticipated third-party financing, then there may also be tax issues associated with cancellation of indebtedness[39] resulting from the uncollectability or forgiveness of the bridge investment. If the bridge investment is structured as debt and later becomes uncollectible, cancellation of indebtedness income may arise at the partnership level and be passed through to the owners. This can be a particularly difficult issue in the partnership context, as the exclusion of cancellation of indebtedness income due to insolvency is tested at the partner instead of partnership level, and capitalizing debt only results in deemed payment equal to the value of the equity received (and if the partnership is underwater, that equity may have little or no value).[40] By contrast, if the bridge investment is structured as equity, it may take longer for the investor to be able to realize a loss with respect to the investment, as compared to the partial debt write-down rules.[41] But assuming the bridge investment is preferred (either as debt or preferred equity), there should be no loss (or uncollectability) of the bridge investment unless all the common equity is wiped out first. There could also be basis issues (e.g., the sponsor might run out of basis for depreciation deductions) for a bridge investment structured as debt unless the investment were to be converted to equity.[42]

RECHARACTERIZATION

If a choice of bridge debt or bridge equity has been made due to tax concerns, but the substance of the structure is not entirely consistent with that choice, then there is a risk of recharacterization. United States tax law looks to substance over form to determine whether an interest denominated as debt or equity should in fact be treated as such.[43] The rules on characterization have developed largely through case law, and generally distinguish between a creditor who seeks a definite obligation that is payable in any event, and an equity holder seeking to invest funds in an enterprise and receive returns according to the profits and losses of such enterprise.[44]

Notes

1 Some states have statutes giving a member of a limited liability company the authority to make a loan to the limited liability company. For example, Del. Code, tit. 6, § 18-107 provides that "[e]xcept as provided in a limited liability company agreement, a member ... may lend money to ... a limited liability company and, subject to other applicable law, has the same rights and obligations with respect to any such matter as a person who is not a member or manager." Although the lending member in a Delaware LLC is still "subject to other applicable law," there is a de minimis exemption from lender licensing in Delaware. Del. Code, tit. 6, § 2202 provides: "(a) Every person desiring to transact the business of lending money in this State shall be required to obtain a license under this chapter; provided, however, that a person that makes not more than 5 loans within any 12-month period shall be deemed not to be transacting the business of lending money. Except as otherwise provided by law, loans made by any such unlicensed lender shall fall under Chapter 23 of Title 6." Chapter 23 is the DE usury statute, but a bridge loan should be exempt. See Del. Code, tit. 6, § 18-505 ("No obligation of a member ... of a limited liability company to the limited liability company ... shall be subject to the defense of usury.").

2 It is worth noting that in certain jurisdictions the title company may be willing to bind a title policy at the time of acquisition that is then "held open" or "bound but not issued" until a later date when the construction phase of the project (and related construction debt) is commenced. Given the variation among jurisdictions, we have not explored the same in detail here.

3 Florida Statutes Title XIV. Taxation and Finance §§ 199.133 (intangible tax), 201.08 (documentary stamp tax).

4 Meinhard v. Salmon, 249 N.Y. 458, 463--464 (1928).

5 See, e.g., Del. Code, tit. 6, §18-107; N.Y. LLC Law § 611.

6 See, e.g., Del. Code, tit. 6, § 18-1101.

7 See, e.g., In re Live Primary, LLC, 2021 WL 772248 (Bankr. S.D.N.Y. Mar. 1, 2021). Recharacterization may depend on the facts, including the intent of the parties, whether the loan is documented and treated as a loan by the parties, and the extent of control the lending member has over the limited liability company.

8 See, e.g., Section 510(c) of the Bankruptcy Code.

9 Given the assumptions in the introduction, this article does not address considerations related to bridge equity that is funded by both the sponsor and the investor.

10 See Appendix A.

11 Id.

12 This may raise tax issues. But it may be treated as an exchange of partnership interests. And under IRS revenue ruling authority, an exchange of partnership interests for new partnership interests generally should be treated as a tax deferred event under §721, provided that there is no shift of capital from the other partners occurring as part of the exchange. Rev. Rul. 84-52.

13 See, e.g., Carey, Real Estate Ventures: Formulating and Interpreting Promote Hurdles and Distribution Splits Ch. 1, §1.8.4 (ABA 2016).

14 However, this may be a distinction without a difference: such deduction may not change the overall allocation of profit and loss between the investor and the sponsor that would occur in the equity scenario. For example, assume: (i) an investor owns 90 percent of the single class of common equity in a venture and the sponsor owns the 10 percent common equity balance; (ii) the investor makes a bridge loan to the venture requiring $20X of interest payments annually until the note is satisfied; and (iii) in a given year, the venture generates $100X of taxable income without regard to the interest payments. If the loan is respected as debt, then there is a potential deduction of $20X for the interest payments, bringing net taxable income down to $80X, and resulting in the investor having $20X of interest income and $72X (90 percent of $80X) of passed-through other taxable income (i.e., total $92X of income), and the sponsor having $8X (10 percent of $80X) of passed-through taxable income. If the loan were instead treated as preferred equity, the first $20X of taxable income would be allocated to the investor under the partnership targeted allocation rules due to the annual accrued preference, and the remaining $80X would be allocated 90/10 to the investor and sponsor, still resulting in total $92X of income to the investor and $8X of income to the sponsor.

15 This may be an important distinction: if accrued interest is paid out of financing or sale proceeds, then the interest may: (i) give rise to income that would not otherwise exist; or (ii) convert capital gain into ordinary income.

16 Treas. Reg. § 1.469-7(c).

17 Treas. Reg. § 1.469-7(g).

18 IRC § 707.

19 IRC § 707(c); Treas. Reg. § 1.707-1(c).

20 IRC § 163.

21 IRC § 263.

22 Treas. Reg. § 1.263A-9(c)(2)(iii).

23 Id. See also Jackson E. Cagle, Jr., 63 TC 86 (1974), aff'd, 539 F.2d 409 (5th Cir. 1976).

24 IRC § 722.

25 IRC § 752; Treas. Reg. § 1.752-2.

26 See, generally, IRC § 856.

27 IRC § 856(c)(4)(A).

28 IRC § 856(c)(4)(B)(i) (25% cap for securities that are not treated as real estate assets), IRC § 856(c)(4)(B)(ii) (25% cap for securities of taxable REIT subsidiaries), IRC § 856(c)(4)(B)(iii) (25% cap on non-qualified publicly offered REIT debt instruments), IRC § 856(c)(4)(B)(iv)(I) (5% cap for securities of one issuer, e.g., the venture, if the security is not treated as a real estate asset or issued by a taxable REIT subsidiary), IRC § 856(c)(4)(B)(iv)(II) (10 percent cap with regard to voting power of one issuer, e.g., the venture, if

the security is not treated as a real estate asset or issued by a taxable REIT subsidiary), and IRC § 856(c)(4)(B)(iv)(III) (10 percent cap with regard to total value of outstanding securities of one issuer, e.g., the venture, if the security is not treated as a real estate asset or issued by a taxable REIT subsidiary). Certain exceptions to the 10 percent cap with regard to total value of outstanding securities of any one issuer are also enumerated at IRC § 856(m), including a provision that provides that such cap shall not apply to debt instruments issued by entities taxed as partnerships where such partnership would meet on a standalone basis the 75 percent qualifying gross income test applicable to a REIT (i.e., requiring such amount of gross income to generally constitute real estate type returns). IRC § 856(m)(4).

29 IRC §§ 856(c)(5)(B).

30 Rev. Proc. 2003-65. See also Letter Ruling 200225034 (March 21, 2002).

31 IRC § 856(c)(5)(B).

32 See, generally, IRC §§ 512 – 514.

33 IRC §§ 512(c), 514, 702(b). See also Rev. Rul. 74-197.

34 See IRC § 514(a)(1), which specifies a percentage determined by the average outstanding balance of the debt for the relevant taxable year divided the average adjusted basis for that period (but not more than 100 percent) and prorated for partial years.

35 Acquisition indebtedness is defined to include not only debt incurred to acquire or improve the property, but also certain past or future debt that is closely tied to the acquisition or improvement of the property. IRC § 514(c)(1).

36 IRC § 514(c)(9). The fractions rule need not apply if either: (i) all the partners are qualified organizations; or (ii) each income or loss allocation to a partner that is a qualified organization is a qualified allocation (which generally requires a fixed percentage); but neither of these alternatives is likely to be available under the assumed facts.

37 IRC § 514(c)(9)(E). Whether preferred returns on equity capital are commercially reasonable is determined on the basis of all of the relevant facts and circumstances. Treasury regulations provide a nonexclusive safe harbor that treats any preferred return as reasonable for purposes of the fractions rule if it is not in excess of the greater of the relevant applicable federal rate (published monthly) plus four percentage points or 150 percent of the applicable federal rate. Treas. Reg. § 1.514(c)-2(d)(4).

38 The dividends from a REIT generally should not be subject to UBTI. IRC § 512(b)(1). Although REITs have certain limitations on income that are similar to those imposed on tax exempts, they do not have acquisition indebtedness rules.

39 IRC § 108.

40 IRC §§ 108(d)(6), (e)(8).

41 IRC § 166.

42 Treasury Regulations provide that a contribution of a partnership's indebtedness by the creditor in exchange for a partnership interest generally is subject to tax deferred treatment similar to other contributions of property. Treas. Reg. § 1.721-1(d).

43 John Kelley Co. v. Comm'r, 326 US 521 (1946); Dunn v. Comm'r, 615 F.2d 578 (2nd Cir. 1980).

44 See, e.g., Comm'r v. Meridian & Thirteenth R. Co., 132 F.2d 182 (7th Cir. 1942); Bauer v. Comm'r, 748 F.2d 1365 (9th Cir. 1984); Farley Realty Corp. v. Comm'r, 279 F.2d 701 (2d Cir. 1960).