Originally published in the:
New York Law Journal ***December 28, 2022***

Tax Court Rules that Loan with Appreciation Interest is Respected as Debt

By: Ezra Dyckman and Charles S. Nelson

Debt and equity can sometimes have very different income tax consequences. When an instrument denominated as debt has "equity-like" features, the question arises as to whether it should be respected as debt or recharacterized as equity for income tax purposes.

In a recent opinion, the Tax Court came to a taxpayer-friendly result on this issue, holding that a mortgage loan with equity-like features should be respected as debt for income tax purposes.

In *Deitch v. Commissioner*, T.C. Memo 2022-86 (Aug. 25, 2022), the petitioners were partners in a partnership that acquired commercial real estate in Georgia in 2006. To finance the acquisition of the property, the partnership obtained a loan from Protective Life Insurance Co. ("PLI"), an unrelated third party. The loan had a fixed interest rate of 6.25%, and, pursuant to a separate Additional Interest Agreement, provided for "additional interest" equal to 50% of the net cash flow and appreciation from the property.

In 2014, the partnership sold its property and paid PLI approximately $1 million of additional interest resulting from the appreciation of the property. The petitioners deducted this amount as interest expense on their tax returns, which they could use to offset ordinary income.

The IRS disallowed the petitioners' interest deductions and argued that the arrangement with respect to the "additional interest" created a joint venture between the partnership and PLI. If the IRS were successful, the amount of additional interest paid would have reduced the petitioners' capital gain from the sale of the property instead of being used to offset ordinary income.

Importantly, the IRS stipulated that the agreement with PLI arose from an arm's-length transaction and that the promissory note, modifications, and security agreement (but not the Additional Interest Agreement) constituted genuine indebtedness.

The Tax Court ruled in favor of the petitioners. The court noted that the promissory note, modification, security agreement, and Additional Interest Agreement were simultaneously bargained for and inextricably linked, and thus could not be separated from one another.

The court stated that PLI's advance to the partnership could not be allocated between debt and equity components, both because the IRS had not made that argument and because there was no evidence that they were separable. In addition, the entire advance could not be treated as equity because the IRS had stipulated that all components of the transaction other than the Additional Interest Agreement constituted genuine indebtedness.

The court held that the loan from PLI to the partnership did not create a joint venture among the parties for income tax purposes. The most important factor in making this determination was that PLI could not be deemed to have made a capital contribution to such a joint venture, since the entire amount advanced by PLI was stipulated to constitute genuine indebtedness.

Among the other factors that indicated a lack of a deemed joint venture were that (1) the agreements stated that the sole relationship between the parties was that of lender and borrower, and the parties acted in accordance with these agreements; (2) PLI did not share pro rata in losses with respect to the property; (3) the business was not conducted in the name of such a joint venture; (4) no partnership tax returns were filed for such a joint venture and the parties did not otherwise represent themselves as a joint venture; (5) no books of account existed for such a joint venture; and (6) the partnership, rather than PLI, exercised primary responsibility and control over rental operations with respect to the property.

Having found that the loan from PLI should be respected as debt and that no joint venture existed, the court ruled that the appreciation interest was paid as compensation for the funds advanced by PLI, and thus the appreciation interest qualified as deductible interest expense.

Much of the Tax Court's opinion in this case focuses on the stipulation made by the IRS that the advance from PLI and the loan documents (other than the Additional Interest Agreement) constituted genuine indebtedness. However, the loan from PLI was economically similar to equity, and had the IRS litigated this case differently, it is not clear that the court would have reached the same conclusion.

Thus, to avoid unintended tax consequences, caution should be exercised when structuring debt instruments that have equity-like features, such as participation in appreciation or net cash flow, particularly when there is no limit to the amount of the appreciation interest that may be paid and the borrower is otherwise thinly capitalized. Nonetheless, this case represents favorable precedent to taxpayers and illustrates that debt instruments with participation features will sometimes be respected for income tax purposes

Ezra Dyckman *is a partner at Roberts & Holland.* Charles S. Nelson *is an associate at the firm.*
