

Mezzanine Debt vs. Preferred Equity: Structuring Commercial Real Estate Financing

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In commercial real estate, financing typically involves a combination of investment types, including senior debt, mezzanine debt, and preferred equity. Mezzanine debt and preferred equity serve as supplemental funding options, often utilized when traditional bank loans or equity financing are insufficient to fully support a business or project's financial requirements. Both are considered hybrid forms of financing as they combine characteristics of both debt and equity.

Understanding the key differences between these financing options, and how each is treated from a tax perspective, can help investors make more informed decisions and potentially maximize returns on their real estate investments.

Mezzanine Debt

Overview and Structure

Mezzanine debt is a financing vehicle that serves as a bridge between mortgage financing and equity. Unlike a mortgage loan, the mezzanine debt is not directly

secured by the property. Instead, the mezzanine lender provides a loan to the parent of the entity that owns the property, securing this loan with a pledge of equity in that entity. This type of debt is subordinate to senior mortgage loans.

The mezzanine lender requires a pledge of 100% of the equity interest in the mezzanine borrower. This means the mezzanine lender holds a lien on the ownership interest of the mezzanine borrower (not the real estate asset itself, which is collateral for the senior mortgage). If the mezzanine borrower defaults, the lender can foreclose on the equity interest and effectively take control of the mezzanine borrower, and through it, the underlying property.

Similar to secured debt, mezzanine debt usually comes with a stated interest rate, periodic payment requirements, and a set maturity date. Lenders may also demand certain control rights over key decisions within the entity. In case of default, they can foreclose on the pledged equity.

Tax Implications

Tax treatment of mezzanine debt is generally straightforward. Typically, sponsors can deduct interest expenses, which the mezzanine lenders then recognize as ordinary income. This straightforward nature and the tax-deductibility of interest are key reasons why mezzanine lenders might prefer mezzanine debt over preferred equity.

It's important to note that mezzanine loans present several challenges for Real Estate Investment Trusts (REITs). To maintain its tax status, REITs must comply with complex rules governing the nature of assets and sources of income. Failure to meet these requirements can lead to severe consequences, including taxation of income from disqualifying sources or even the loss of REIT status. While REITs are explicitly permitted to hold interests in mortgages, the rules are silent regarding mezzanine loans. This ambiguity has led many REITs to exercise caution in owning mezzanine loans.

Preferred Equity

Overview and Structure

Preferred equity investors provide capital to an entity that either owns or controls the property directly. Unlike secured debt, these equity investments are unsecured and only receive distributions after all other obligations have been met. If a sponsor defaults, preferred equity investors cannot foreclose on the property or initiate involuntary bankruptcy proceedings.

Preferred equity structures can be tailored to the specifics of each transaction and the tax situations of the investors. Many commercial real estate investors favor preferred equity because it ranks above common equity and can resemble debt in its structure. Preferred equity holders often enjoy a prioritized return on their investment and the possibility of accelerated repayment of their initial contributions. This arrangement allows them to benefit from the project's success, rather than merely receiving a fixed return and capital repayment.

Returns on preferred equity can be classified as either guaranteed payments or income allocations. The treatment depends on several factors, such as whether the preferred return is paid in all events, whether is paid annually, and whether the partnership has income at least equal to the amount of preferred return.

Tax Implications

If treated as guaranteed payments (even if it is not paid annually), investors recognize ordinary income, and the partnership benefits from a corresponding tax deduction. However, recognizing ordinary income without actual distributions can be problematic for investors. As a result, many investors prefer not to treat the accruing preferred returns as guaranteed payments, opting to allocate income only when the partnership generates income or at the exit.

When the preferred return is treated as an income allocation, partners must determine how to allocate taxable income and loss, and whether to allocate net or gross items. The allocations can become complicated, particularly in loss years. Advisors often believe that preferred equity holders should receive a share of gross income in years of tax loss. Phantom income allocation can create challenges and is generally unappealing to investors.

Debt vs. Equity

The choice between debt and equity financing is significantly influenced by the investor's tax status. For example, tax-exempt investors investing in equity are subject to the unrelated business income tax on the "debt-financed" portion of their return unless they meet complex requirements for a "qualified organization. On the other hand, if the investment is treated as debt, their income might be tax-free.

Given the various structures and flexibility involved, it's important for parties to clearly outline their intended treatment of the preferred return in the partnership agreement. Ambiguities in these agreements can lead to future disputes, making it critical for real estate owners to carefully review and assess all financing options before committing to a particular strategy.

For more information on structuring Commercial Real Estate Financing, please contact [Aleksander Dziedzic](#), Partner, or your Anchin Relationship Partner.