

Commercial Real Estate

Expert Insight

A developer's guide to carried interest proposals

By **Steven Schneider**
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Legislation to tax the "carried interest" of typical real estate partnerships, or limited liability corporations, has been lurking around Washington since 2007, but there are signs the proposal could finally see the light of day later this year.

The measure has been approved by the House each time it has been proposed, but it has always hit a road block at the Senate. This year, however, the Senate actively considered the legislation and proposed compromise rules that almost became law in July. They may very well be resurrected later this year.

Here's an overview of the most recent Senate version – likely to be closest to any law that may ultimately be passed – and some tips on what developers should consider now.

- The legislation would raise tax rates, even on existing deals. The measure is based on the idea that a carried interest should be taxed more like a salary, subject to the higher ordinary income rates and employment taxes. As a compromise, the Senate proposed to treat only 75 percent of carried interest as compensation income. Even after this compromise, the effective tax rate would almost double if the underlying income would otherwise be long-term capital gains.

The legislation, proposed to take effect next year, would cover both new and existing partnerships. The scheduled 2011 top federal tax rates are 20 percent for long-term capital gains and 42.5 percent for compensation income. For a "top tax bracket" developer, taxing 75 percent of a \$100 long-term capital gain as compensation would increase the federal tax from \$20 to \$36.88. If the asset is held at least five years, a special rule treats only 50 percent as compensation, making the tax \$31.25.

- The legislation would deny deductions, raising taxes even without a sale. The legislation would defer tax deductions that relate to the 75 percent portion of the carried interest so they can only be used against future ordinary carried interest income. This would be applied on a per partnership basis so that the suspended deductions can only be used against future carried interest from the same partnership.

- The legislation would tax the developer on property distributions and interest transfers. To stop taxpayers from avoiding the carried interest tax by swapping out the partnership interest for another asset, the

legislation may accelerate some or all of the carried interest tax whenever the developer receives property distributions from the partnership or transfers or exchanges the partnership interest for another asset.

What can you do now?

If a developer is considering cashing out, there may be significant tax savings to selling out before the new could take effect. Unfortunately, selling depreciable real property to

a related party converts the gain to ordinary income, so it's best to find an unrelated buyer. Another option is to consider converting the carried interest to a non-carried interest in an operating partnership of a REIT, before the legislation becomes effective. If that is not possible, it may still be beneficial to document partnership interests so that the carried interest is clearly separate from the developer's side-by-side capital in the hopes that the side-

by-side capital is not also tainted with the carried interest tax.

Finally, estate planning may include a tax-basis step up at death in the carried interest, although the legislation is not clear on whether a stepped up basis is still available for the carried interest.

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Leasing

NASA contractor signs Greenbelt lease

Trax International has signed a lease for 120,000 square feet in Greenbelt that will house two projects the contractor is working on with NASA's Goddard Space Flight Center. A mix of government employees and members of the Las Vegas-based firm will move into the space at 7700-7720 Hubble Drive this fall. The office building is owned by Bethesda-based MGP Real Estate LLC. The projects' staff will work on including the Joint Polar Satellite System project and the Polar Operational Environmental Satellites project. The JPSS project is a partnership between NASA and the National Oceanic and Atmospheric Administration.

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