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The Carried Interest Tax Increase & Its Impact on Real Estate Partnerships

ICSC Webinar



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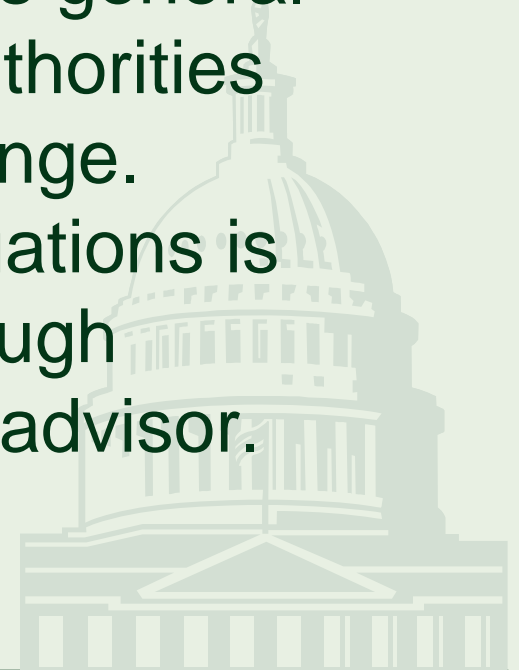
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Disclaimer

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Any tax advice in this presentation is not intended to be used for the purpose of avoiding tax penalties. The information contained is general in nature and based on authorities that are subject to change. Applicability to specific situations is to be determined through consultation with your tax advisor.





What is a Carried Interest?

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- Legislation broadly defines Carried Interest to include any partnership interest:
 - not related to a qualified capital investment
 - held by a person who performs specified investment manager services for a financial investment partnership.
- Private Equity / Hedge Fund Managers structure funds with a 2 & 20 compensation structure.





Carried Interest in Real Estate

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- Commonly used by real estate partnerships for more than 50 years.
- Often referred to as “the promote,” “the sponsor’s share,” or the “back-end piece.”
- Recognizes the pursuit costs and the guarantee of debt/other liabilities on behalf of the partnership.
- Often not realized until after meeting “the hurdle” rate.
- Does not include fees for leasing, management, construction and other services which are separate and treated as ordinary income.



The Legislative Timeline

2007 – Introduction

- Academic paper released by Prof. Victor Fleischer
- Legislation introduced by Rep. Sander Levin (D-MI)
- Hearings held in House and Senate
- Passed the House as an offset for temporary tax extenders

2008 – Passed by the House

- Passed the House as an offset for AMT Relief
- Senate declines to consider legislation

2009 – Passed by the House

- Passed the House as an offset for temporary tax extenders
- Senate holds off consideration for larger tax reform debate

2010 – Passed by the House

- Passed the House as part of “the American Jobs and Closing Tax Loopholes Act of 2010”
- Senate unable to move legislation forward (3 failed votes)



Current Carried Interest Tax Proposal

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- Effective Date: Taxable years after 12/31/2010.
- Applies to old and new partnerships (no grandfathering).
- Applies to persons (or related persons) who:
 - Directly or indirectly provide substantial investment, management or financial services;
 - Services relate to certain investment assets (including rental and investment real estate) held directly/indirectly by the partnership.



Carried Interest – By the Numbers

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Type of Income:	Current:	Future:	Effective Rate:
Operating income	35%	75% @ 39.6% + 3.8% 25% @ 39.6%	42.45% 21% tax increase
Capital gain < 5 years	15%	75% @ 39.6% + 3.8% 25% @ 20%	37.5% 150% tax increase
Capital gain > 5 years	15%	50% @ 39.6% + 3.8% 50% @ 20%	31.7% 111% tax increase

*Ordinary Income and Capital gain rates currently scheduled to increase to 39.6% and 20%, respectively, when Bush tax cuts expire, regardless of Carried Interest legislation.

** An additional 12.4% tax would apply to the extent total compensation income is below the social security wage base (currently \$106,800)

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Qualified Capital Exception

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- Developer can exclude “Qualified Capital” that is intended to be the “side-by-side” capital the developer puts in with the investors.
- Use of loans from investors to developer or partnership does not circumvent this rule.





Family Partnerships-Pro Rata Exception

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- Many partnerships would have failed the Qualified Capital exception because all partners are service partners, or in a family partnership all partners are treated as service partners because they are related to the service partner.
- Current version includes “pro rata” exception to help some cases.
 - Exception applies if all distributions and all allocations of the partnership (or lower tier partnerships) are made pro rata on the basis of the capital contributions of each partner.



Tax Acceleration

Tax on Carried Interest is accelerated if:

- Developer transfers Carried Interest (even transfers to family partnerships or REIT operating partnerships).
- Developer receives property distributions from the partnership.
- Partnership merges into another partnership.

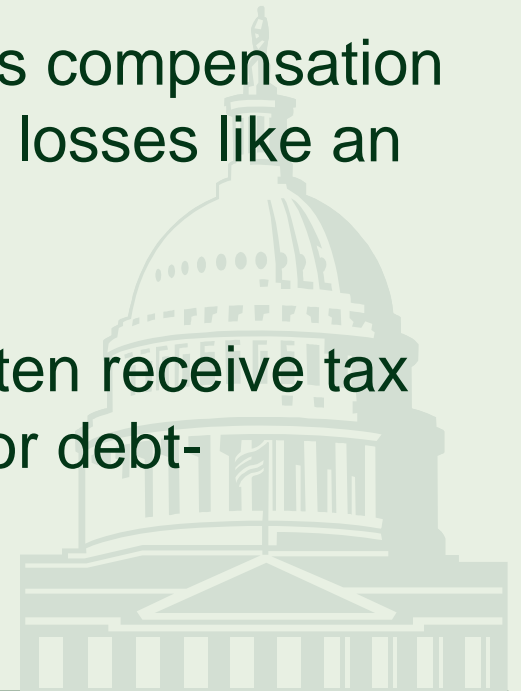
In limited cases the Developer can elect to avoid the gain if the Carried Interest taint is carried over to the new partnership.





Loss Deferral

- Tax losses otherwise flowing through 75% / 50% tainted portion of Carried Interest are deferred and can only be used against future Carried Interest income from that specific partnership.
- The idea is that Carried Interest is compensation income and shouldn't receive tax losses like an investment.
- Under current law, developers often receive tax losses because they are at risk for debt-guarantees, but not anymore.





Changing the Character

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- Higher tax rates.
- Additional Medicare taxes.
- Additional social security taxes.
- Ordinary income cannot be offset by capital losses.
- Potential estate planning implications.





Corporate / REIT Impact

- **No Exemption for Corporations**
 - Although C corporation's pay the same tax rate for ordinary income and capital gain, the loss deferral rules, income acceleration rules, and general character matching rules could have substantial impact.
- **REIT impact**
 - Not intended to change income qualification for REITs.
 - Could significantly increase REIT distribution requirements because tied to taxable income which is increased by income acceleration/loss deferral rules.
 - Special rule for publicly traded partnerships.





Impact on Future Business Decisions

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- Risk → Reward ↓
 - Riskier projects will not make “post tax” economic sense.
 - Higher barrier of entry for smaller developers.
 - Increases the cost of capital.
 - Tax benefits no longer tied to debt guaranties.
 - No longer able to offset losses.

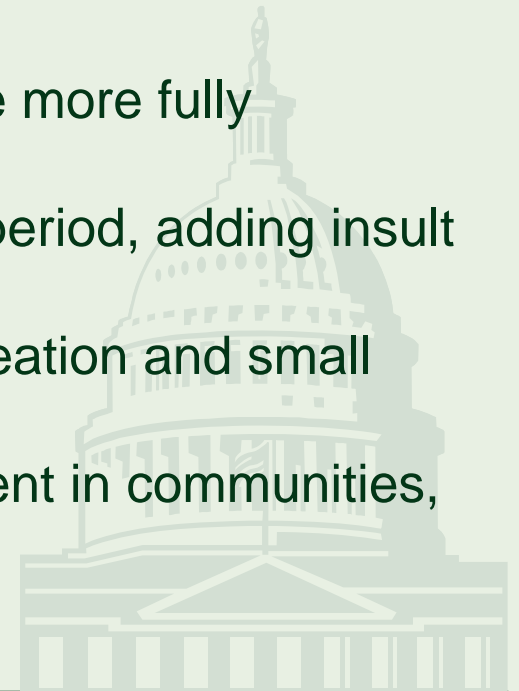




Looking Ahead

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- The next 3 weeks are critical
 - Senate wants to move legislation before August break.
- Tell your story
- Basic Talking Points:
 - This is bad tax policy that needs to be more fully examined.
 - Comes at particularly bad economic period, adding insult to injury for commercial real estate.
 - Will have a negative impact on job creation and small businesses .
 - Congress should encourage investment in communities, not stifle capital creation.



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