

New Bill Will Tax Real Estate “Promote” as Carried Interest Subject to Three-Year Holding Period

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Senators Manchin and Schumer this week announced that the “Inflation Reduction Act of 2022” will be added to the FY2022 Budget Reconciliation bill.¹ The bill includes changes to Section 1061 of the Code (which was added to the Code in 2017 by the Tax Cuts and Jobs Act “TCJA”).² Foremost among these changes for real estate operators and investors is that so-called “Section 1231 gains” (which encompass gains from the sale of real property used in a trade or business) will now be subject to a three-year holding period in order for carried interest holders to get the benefit of long-term capital gain rates. Thus, if the new bill is enacted, real estate “promote” will generally be taxed as short-term capital gain unless the holding period requirements described below are met.

Background

Section 1061 as enacted by the TCJA generally extended the required holding period for certain carried interests from one year to three years in order for the taxpayer holding the carried interest to get the benefit of long-term capital gain rates. As enacted, Section 1061 did not apply to carried interests if the carried interest was realized as a distributive share of gain from the sale of real property used in a trade or business. Thus, many real estate investors and operators who receive “promote” in real estate transactions continued to be taxed at long-term capital gain rates on their promote without meeting the three-year holding period.

The new bill would expand the application of Section 1061 to encompass gains from the sale of real property used in a trade or business (as well as other items, such as qualified dividend income, that are taxed at preferential rates but are not technically capital gains under the tax law). As a result, real estate investors and operators who receive “promote” will now generally be subject to tax at short-term capital gains rates unless they meet the three-year holding period requirements.

Other Changes

In addition to expanding the scope of gains which are subject to Section 1061, the bill makes several other significant changes to the taxation of carried interests:

1. Carried interests that are not from gains from real property used in a trade or business would be subject to a five-year holding period, except for taxpayers with an AGI of \$400,000 or less, who would get the benefit of a three-year holding period.
2. The holding period would be measured as the later of (a) the date on which the service provider acquired substantially all of the carried interest with respect to which the amount is realized, or (b) the date on which the entity in which such carried interest is held acquired

substantially all of the assets held by such entity. This means that, e.g., an individual service provider who receives a promote interest does not get the benefit of the promote entity's holding period in the underlying asset. This may also bring into question at what point the holding period begins with respect to real estate development projects.

3. Transfers of carried interest would be subject to tax at short-term capital gain rates, even if a non-recognition provision would otherwise apply.

The bill calls for Treasury to issue regulations in order to:

1. Prevent use of distributions or carry waivers to avoid the carried interest rules; and
2. Provide for the rules of Section 1061 to apply to other arrangements such as financial instruments, contracts or interests in entities other than partnerships.

The proposed change in law would be effective for tax years beginning after December 31, 2022.

¹<https://www.democrats.senate.gov/newsroom/press-releases/senate-majority-leader-chuck-schumer-d-ny-and-sen-joe-manchin-d-wv-on-wednesday-announced-that-they-have-struck-a-long-awaited-deal-on-legislation-that-aims-to-reform-the-tax-code-fight-climate-change-and-cut-health-care-costs>.

²<https://www.goulstonstorrs.com/publications/tax-reform-advisory-real-estate-industry/>