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A Real Estate Developer's Guide to Carried Interest Legislation

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The developer's promote or "Carried Interest" is under attack by Congress.[1] The wealth of Hedge Fund managers has caught the eye of the legislators and now Congress wants to nearly double the tax rates for fund managers in a way that extends into the typical real estate partnership or LLC. The legislation has been lurking around Washington since 2007 and has been approved by the House each time proposed, but it always hit a road block at the Senate. However, this year the Senate actively considered legislation and proposed compromise rules that almost became law in July and may be resurrected later this year. This article provides an overview of the most recent Senate version, which is likely to be closest to any law that may ultimately be passed.

The legislation raises tax rates, even on existing deals. The legislation 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% 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 as proposed is to be effective starting in 2011, covering both new and existing partnerships. The scheduled 2011 top federal tax rates are 20% for long-term capital gains and 42.5% for compensation income (39.6% income tax plus 2.9% self-employment tax). Therefore, if a "top tax bracket" developer would otherwise receive a $100 long-term capital gain, taxing 75% of the capital gain as compensation means that the federal tax would increase from $20 to $36.88. If the asset is held at least five years, a special rule treats only 50% as compensation so the tax in such situation would be $31.25.

The legislation denies deductions, raising taxes even without a sale. The legislation defers tax deductions that relate to the 75% "tainted" portion of the Carried Interest so that they can only be used against future ordinary Carried Interest income. This is applied on a per partnership basis so that the suspended deductions can only be used against future Carried Interest from the same partnership. For example, if the Carried Interest would otherwise provide $100 of net deductions in 2011, $75 of the 2011 deductions would be suspended. The deductions would still be available to offset future ordinary income from that specific Carried Interest, such as upon sale of the underlying asset. Additional suspended deductions could occur if the developer guarantees a greater share of debt than its share of capital. Thus, even though many think of the Carried Interest tax as a back-end issue, the tax hit can be much sooner because these suspended deductions could cause other unrelated income to no longer be sheltered.

The legislation taxes 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 (1) receives property distributions from the partnership, or (2) transfers or exchanges the partnership interest for another asset. There is an exception on some common exchanges that allows people to elect to carry over the Carried Interest taint to another partnership interest. Unfortunately that exception does not cover a lot of common transactions, including a simple liquidation of a lower-tier partnership or, in some cases, the transfer of a Carried Interest to a family member.

Carried Interests may include the developer's side-by-side equity. Although the proposed legislation purports to exempt the developer's equity investments from the new tax, the exception is too narrow. The income from the developer's cash or property investments are excluded only if the developer's return on that equity and liquidation priority is comparable to that held by an unrelated equity investor in the partnership who does not provide investment services. If there is no unrelated equity investor to compare to, the default rule is that the entire interest is subject to the higher taxes on Carried Interest unless a narrow exception applies for partnerships with only pro rata sharing or the IRS writes regulations providing more favorable rules.

What can you do now? If a developer is otherwise considering cashing out, there may be significant tax savings to selling out before the new law may 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 that may reduce taxes is to consider converting the Carried Interest to a non-Carried Interest in an operating partnership of a REIT, preferably before the legislation becomes effective. If such a significant legal and economic change 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. Given the pitfalls and potential planning opportunities associated with Carried Interests and the uncertainty of future legislation, developers should consult their tax advisers when considering transactions involving Carried Interests.

For questions regarding the information contained in this G&S Advisory please contact your usual Goulston & Storrs attorney, any member of the **Tax Group** or:

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[1]For more information on what is a Carried Interest and the House version of the proposed legislation see Goulston & Storrs June 2010 Client Alert titled "House-Passed Carried Interest Legislation: Impact On Real Estate Partnerships – A Developer's Perspective."