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House-Passed Carried Interest Legislation: Impact On Real Estate Partnerships – A Developer's Perspective

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Congress appears poised to rewrite the tax play book for real estate partnerships, significantly increasing taxes on the majority of the developer's Carried Interest (also known as a "promote")[1]. This legislation extends far beyond investment funds and dramatically changes the taxation of the developer in the typical real estate operating partnership. As currently drafted[2], the rules may curtail the ability of real estate developers to use tax depreciation and other losses from the property and would accelerate tax on certain transfers of the Carried Interest. This summary is based on the House-passed version, which is currently proposed to be generally effective on January 1, 2011. The Senate is expected to follow a similar format as the House, with the current Senate draft using a slightly lower blended tax rate.[3] At its essence, the House version of the legislation recasts 50% of the Carried Interest as ordinary income (as opposed to potential capital gain) starting in 2011, increasing to 75% in 2013. After the increase to 75% and other scheduled tax rate increases, the blended federal marginal rate for the Carried Interest will be 37.55% starting in 2013.[4]

Five Things Every Developer Should Understand

1. Significant increase in tax rates on Carried Interests. For 2011 and 2012, the tax rate for capital gains attributable to the Carried Interest will increase from 20%[5] to a blended rate of 31.25%, a 56.25% tax rate increase. For 2013, the blended rate will rise to 37.55%, an 87.75% tax rate increase. Because there is no exclusion for accrued Carried Interest based on untaxed appreciation earned before the effective date, many view the tax increase as retroactive. For example, a developer who first received its Carried Interest in 2000 and sells its interest on January 1, 2011 would be subject to the new tax rules on the entire gain, even though the gain was earned before the effective date of the legislation.

2. Qualified Capital is narrowly defined. The legislation does not apply to Qualified Capital the developer receives for money or property contributions. Qualified Capital is also increased by (1) taxed but undistributed partnership earnings; and (2) the amount the developer reports as taxable compensation income upon the receipt of the Carried Interest.[6] However, the default test for Qualified Capital is very narrow. In general, the Qualified Capital exception is limited to developer capital that earns the same economic return as comparable "significant" capital from non-service providers. Thus, a developer can own a non-tainted "Investor" interest mirroring other Investor partners, but the Carried Interest is still tainted. Moreover, the developer cannot boost its Qualified Capital by (a) borrowing from the other partners to make a capital contribution, or (b) structuring the other partners' investment as mostly debt.

3. Single-property partnerships included. Although originating with hedge funds, the legislation also covers Carried Interests in single-property partnerships. Specifically the rules cover a Carried Interest received for managing, acquiring, arranging financing for, or disposing of certain "specified assets" which include real estate and "interests in partnerships."[7]

4. No loss netting between different Carried Interests. The legislation only permits tax losses from the ordinary portion of the Carried Interest to offset Carried Interest income from that same partnership. Although a developer will still be allowed the losses from its Qualified Capital interest, it is likely that tax losses stemming from developer guarantees will be suspended.

5. Carried Interest income accelerated on certain cashless transactions. Many transactions that are tax-free under current law will now create phantom income on the Carried Interest. For example contributions to a family limited partnership or contributions to a REIT's operating partnership accelerate gain on the tainted percentage of the Carried Interest unless the developer elects to carry over the ordinary income taint to the partnership interest received. However, this election is not available for contributions to corporations (including REITs) or distributions of lower-tier partnership interests that are not part of a partnership merger, division, or technical termination.

What do I do now? Five things to discuss with your tax advisor.

1. The legislation isn't even final – should I do something now? You should review the legislation with your advisor as soon as possible; the January 1, 2011 general effective date provides a short but meaningful window to take into account the considerations outlined above. In particular, there is significant value in (1) avoiding unintended disqualification of contributions as Qualified Capital, (2) preserving future flexibility in documents, (3) considering accelerating taxable income in 2010 that relates to a Carried Interest, and (4) planning cash flow needs to pay the future taxes. Tax distribution provisions are particularly troublesome because the legislation would increase the tax rate for some but not all partners, creating the need to consider non-pro rata tax distributions (or tax loans) for the developer's disproportionately higher tax. For existing LLCs, amending the tax distributions may take some time to complete before the January 1, 2011 effective date.

2. Clean up your Qualified Capital. The legislation exempts Qualified Capital, but many agreements combine the developer's capital and service interest into a single interest that is difficult to separate out. For new deals it may be relatively simple to separate out the interests into an "A" interest and a "B" interest or separate out developer-owning entities. However, for older deals you might try to amend the documents and, where you cannot amend the documents, your accountant will need to separate the two capital classes.

3. Build flexibility into future documents. Consider adding a savings clause in partnership and LLC agreements to make it easier to restructure to accommodate for the new legislation. The legislation has many open questions that will likely take years to reach resolution, and maximum flexibility is best to avoid foot-faults. Future documents should also address the potential that the different tax treatment of the developer creates a possible conflict among the partners.

4. Keep good records to track Qualified Capital. Qualified Capital includes net aggregate contributions and previously taxed income that has not been distributed, including amounts before the effective date of the legislation. This means it is important to track this information both on a going forward basis as well as to go back and gather data for prior years.

5. Is it time to trade the Carried Interest for a service fee? To the extent that there are similar economics between a contingent fee and a Carried Interest, is one better than the other? This is a question that has no one-size-fits-all answer, but generally, the

Carried Interest structure still may offer tax advantages to the extent the underlying gains are long-term capital gains, or if there are current tax losses flowing through the Carried Interest. Because the legislation is limited to the relevant 50% or 75% applicable percentage, 25% - 50% of the gain (or loss) is not tainted and provides favorable tax benefits. Other considerations are important though, such as differences in when the income is reported and in the way deferred compensation classification applies to Carried Interests, contingent fees or possibly to options.

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] The Carried Interest represents a percentage of profit allocated to the Developer that exceeds the Developer's share of capital. For example, a Developer may contribute 1% of the capital and after a minimum preferred return is paid on all capital, the Developer may receive an additional 20% of profits beyond its 1% capital share. This 20% is the Carried Interest.

[2] See H.R. 4213 as passed by the House on May 28, 2010.

[3] The Senate Finance Committee draft version, released on June 8, 2010, by comparison lowers the ordinary income percentages starting in 2013 to 65% generally and to 55% for gains on property held at least seven years.

[4] For simplicity the following assumptions are made in the calculations herein: (1) all scheduled income tax increases arising from the scheduled expiration of the George W. Bush tax cuts will take effect; (2) the underlying income would have been subject to long-term capital gain treatment, which would not be the case with a Carried Interest paid from operating profits; (3) the applicable 50% or 75% of the Carried Interest income is subject to the special 3.8% Medicare tax provided in the proposed legislation; and (4) the developer would not have been subject to the Medicare taxes under new section 1411 on the Carried Interest income. Note that starting in 2013 most capital gains will be subject to the 3.8% Medicare tax under new Section 1411 regardless of the Carried Interest legislation, although this tax may not apply to real estate developers if they are viewed as in the active conduct of a trade or business under the passive activity rules.

[5] The current 15% rate on capital gains is scheduled to increase to 20% regardless of the Carried Interest legislation.

[6] The legislation mandates that a profits-only Carried Interest is valued at zero for this purpose, therefore creating zero Qualified Capital.

[7] The legislation implies that it is limited to certain industries, such as real estate, through a limited list of "specified assets" covered. However, because the specified assets include "interests in partnerships", other industries are literally covered if they use a holding company structure such that the Carried Interest is held in an upper tier partnership that has an interest in a lower tier partnership.