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Carried Interest Legislation May Cover More Than You Think

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By now, most real estate professionals are aware that proposed legislation to limit the favorable tax treatment of "carried interests" does not affect only hedge fund managers. However, many do not realize the surprising (and sometimes shocking) breadth of arrangements involving investment in real estate that appear to be covered. While the legislation's progress may have stalled, most prognosticators predict that, in part because the legislation has been deemed to be a revenue raiser, some form of the legislation eventually will be enacted with an effective date of January 1, 2011. It is true that these may be the same people who told us that it was inconceivable that Congress would allow the estate tax to lapse for 2010. Still, given the plentiful opportunities for effective tax planning which now are available, but which would have to be carried out prior to the legislation's effective date, potentially affected real estate professionals must consider whether they can afford the possible cost of doing nothing.

Background

The term "carried interest" refers to the share of partnership profits that partners receive other than in exchange for contributed capital. This term is often used to describe a share of the profits of a hedge fund or private equity fund which the fund manager receives as compensation for his services. However, a structurally similar arrangement is that of a real estate professional who receives a share of the profits of a partnership that owns real estate in exchange for his management services.

As a result of a partnership's pass-through nature for Federal income tax purposes, a carried interest's allocation of long-term capital gain and qualified dividends is taxed at the favorable rates which are generally afforded to those items. In part as a backlash against certain high profile lavish displays of wealth by hedge fund managers, politicians began considering whether this income should be taxed at ordinary income rates like normal wages.

Carried Interest Legislation

In May, 2010, the House of Representatives passed a bill which, with certain exceptions, generally treats allocations of income received by carried interests as ordinary income. In June, 2010, the Senate Finance Committee set forth a substitute amendment, which in general is similar to the House bill. The Senate has not as of yet been able to obtain cloture on this legislation. Both the House bill and the Senate amendment currently have an effective date of January 1, 2011. Note that this effective date results in partnership structures created many years ago being subject to the carried interest provisions to the extent income is recognized after 2010.

This carried interest legislation covers "investment services partnership interests," which it generally defines as partnership interests held by any person if it was reasonably expected at the time when the person acquired the interest that the person (or a related person) would provide a "substantial quantity" of certain enumerated services with respect to certain enumerated assets of the partnership. The enumerated services include management, investment advice (including advice relating to purchase and sale), arranging financing, and activities in support of these services. The enumerated assets include "real estate held for rental or investment" and "interests in partnerships."

Net income and net loss with respect to an investment services partnership interest ("ISPI") are generally treated as ordinary income or loss. However, net losses are allowed only to the extent of the excess of aggregate net income over aggregate net loss from prior years. Gain upon the disposition of an ISPI is treated as ordinary income, while loss upon the disposition of an ISPI is treated as an ordinary loss only to the extent of prior net income (and otherwise is treated as a capital loss).

In general, a partner is not subject to any tax upon receipt of a distribution of property from a partnership which is not received in liquidation of the partner's interest in the partnership (and the partner receives a "carryover" basis in

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the distributed property). However, under the carried interest legislation, a distribution of property by a partnership to the holder of an ISPI is treated as a cash distribution, so that the ISPI holder recognizes gain to the extent of the excess of the amount of the distribution over the tax basis in his partnership interest.

The most recent drafts of the carried interest legislation have modified the portion of the income attributable to ISPIs that is covered by the legislation, leaving most of the technical framework intact. With respect to an ISPI held by an individual, the House bill governs only 50 percent of the ISPI for tax years beginning before January 1, 2013, and otherwise governs 75 percent of the ISPI. The Senate amendment generally governs 75 percent of an ISPI held by an individual, but governs 50 percent of the net income or loss resulting from the sale of an asset which has been held by the partnership for at least 5 years.

The legislation does not apply to certain "qualified capital interests," i.e., interests in a partnership that are received in exchange for the contribution of property (and not in exchange for services). However, the portion of a service provider's ISPI that is a qualified capital interest is exempted from the legislation only if (1) allocations to this qualified capital interest are made in the same manner as allocations to qualified capital interests held by unrelated partners who do not provide services, and (2) allocations to qualified capital interests held by partners who do not provide services are "significant" compared to the allocations made to the service provider's qualified capital interest. A qualified capital interest does not fail to meet these requirements merely because allocations made to the qualified capital interest represent a lower return than allocations made to qualified capital interests of partners who do not provide services to the partnership.

Under the House bill, if one partner provides services and all of the other partners are related to the service-providing partner (or all of the partners provide services), the partnership interest of the service provider would be governed by the legislation even if all of the partnership's allocations were made strictly pro rata. At the urging of commentators, the Senate amendment corrects this illogical result by providing that, if all of a partnership's distributions and allocations are made pro rata on the basis of capital contributions that constitute qualified capital interests, no interest in the partnership is governed by the legislation.

Surprising Applications

The carried interest legislation covers numerous arrangements relating to carried interests held by real estate professionals, which may be a surprise to many. The following are examples of a few such scenarios. In each scenario two partners (Sidney and Norman) form a partnership that will operate rental real estate. Sidney will provide management services to the partnership and Norman will not provide any services.

Scenario 1: Sidney provides management services to the partnership in exchange for a fixed annual fee (i.e., not a percentage of the partnership's profits). Sidney and Norman each contributes $500,000 of capital to the partnership. Since Sidney is less risk-adverse than Norman, they agree that the first $800,000 of profits will be allocated 37.5 percent and 62.5 percent to Sidney and Norman, respectively (after which Norman will have recovered his entire $500,000 contribution). Sidney will then be allocated the next $200,000 of profits (after which Sidney will have recovered his entire $500,000 contribution). Thereafter, all future profits will be allocated 55 percent and 45 percent to Sidney and Norman, respectively.

In this scenario, allocations to Sidney's qualified capital interest are not made in the same manner as allocations to Norman's qualified capital interest, and it is possible that allocations to Sidney's qualified capital interest could represent a higher rate of return. Therefore, Sidney's entire partnership interest would be governed by the legislation -- notwithstanding the fact that (1) Sidney is not allocated any profits in exchange for his services and the unequal method of allocations results only from their differing risk preferences and (2) depending on the partnership's profits, allocations to *Norman's* qualified capital interest may end up representing a higher rate of return. In fact, if Norman provided an equal amount of services to the partnership as does Sidney (so that it would be clear that the unequal method of allocations was unrelated to the provision of services), both of their partnership interests would be governed by the legislation.

Scenario 2: Sidney again provides management services to the partnership in exchange for a fixed annual fee. Sidney and Norman each contributes $500,000 to the partnership and is allocated 50 percent of all partnership profits. In addition, Norman pays $50,000 of the partnership's operational expenses, which the partnership will repay to him at a later date.

Assuming that Norman's $50,000 payment of partnership expenses is considered to be a loan to the partnership, this loan will increase the amount of Norman's qualified capital interest. Since both Sidney and Norman are allocated an equal 50 percent of the partnership's profits, but Norman's qualified capital interest would be considered to be greater than Sidney's, allocations to Norman's qualified capital interest would represent a lower return. Therefore, at least a part of Sidney's partnership interest would be governed by the legislation.

Scenario 3: Sidney and Norman formed the partnership in 1990. Sidney performed services for the partnership from 1990 to 1995 in exchange for an interest in the partnership. Sidney has provided no further services since 1995 and will provide no services in the future. In 2011, after the effective date of the legislation, oil is discovered on the property owned by the partnership and the partnership sells its property, which had been valued at only $2 million before the oil discovery, for $50 million.

Sidney's interest in the partnership is governed by the carried interest legislation, notwithstanding the fact that he will provide no services after the effective date of the legislation. Thus, alt-

hough Sidney's share of the partnership's oil profits does not appear to represent wages to Sidney, it nonetheless would be treated as ordinary income.

Scenario 4: Sidney and Norman formed the partnership in 2009, with Norman providing $1 million of capital and Sidney providing no capital. They agreed that Norman will receive the first $1 million of distributions, and then they will share all subsequent distributions 50-50.

In this scenario, it appears that, even after Norman recovers his $1 million contribution and they begin sharing distributions 50-50, Sidney's entire partnership interest would continue to be governed by the legislation. Moreover, it appears that this would be the result not only if Norman recovers his $1 million contribution after the effective date of the legislation, but even if he recovers it before the legislation's effective date.

Conclusion

The carried interest legislation leads to numerous outcomes that may surprise real estate professionals. While it is uncertain whether this legislation will be enacted, effective tax planning prior to the end of the year (in the form of gain acceleration or partnership restructuring) may be able to avoid many of the undesirable consequences of the proposed legislation. Can you afford to wait?