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Real Estate Alert

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# Congress Considers Changes to Tax Treatment of Carried Interests that May Affect UPREITs and DownREITs

The recent Congressional focus on hedge funds has led some members of the tax-writing committees to consider tax changes that could generally affect investment funds, and also many real estate investment trusts that hold their properties in partnerships (in so-called "UPREITs" and "DownREITs") and their managers. In particular, these changes could include treating "carried interest" allocations to a general partner or managing member in an UPREIT or DownREIT as ordinary compensation income rather than capital gains.

General partners or managing members (referred to below as "managers") of the operating partnership in an externally managed UPREIT or DownREIT often receive a fixed management fee each year based on net assets under management, and a "carried interest" entitling them to some portion of the operating partnership's profits. The carried interest is typically structured as a partnership profits interest. Under current law, this ensures that the managers will not be taxed on receipt of the carried interest and that carried interest allocations will retain the character of income earned by the partnership. Thus, if the UPREIT or DownREIT earns long-term capital gains, carried interest allocations will be taxed at a maximum federal tax rate of 15% to the extent these allocations are ultimately made to individuals (either directly or through the general partner or managing member, which is itself a partnership for tax purposes).

Congress is apparently beginning to consider whether the tax benefits associated with profits interests—generally deferral and conversion (i.e., treating carried interest allocations as capital gains rather than ordinary income) —are appropriate for hedge funds and other large private investment funds including real estate funds. A paper by Professor Victor Fleischer, quoted in a recent New York Times editorial, frames the issue as whether the tax law should allow "some of the richest workers in the country to pay tax on their labor income at a low rate."

The focus on the taxation of carried interests flows from the general focus on hedge funds and from the reinstatement of the "pay as you go" rules. Democrats have pledged to pass targeted tax incentives, such as additional energy conservation and education incentives. Under the reinstituted "pay as you go" rules, these tax cuts would need to be offset by tax increases. Because Democrats have foresworn any broad-based tax increases, the tax staffs are closely reviewing the tax code for proposals that would increase revenue by closing "loopholes" or increasing compliance (such as through increased penalties). Thus, the recent Senate version of the minimum wage bill contained a provision that would limit deferrals of compensation (a tax benefit also utilized by offshore fund managers) to the lesser of $1 million or the average compensation received over the five previous years.

The staff's scrutiny of carried interests may be further encouraged by the April 2, 2007 New York Times editorial mentioned above. Entitled "Taxing Private Equity," the editorial notes that the tax staffs are reviewing the issue, and urges them forward, arguing that, under the current system, "the nation in effect waits longer for its tax revenue and gets less, as private equity partners get more."

No specific legislation is under consideration, and no particular approach has been determined. The Fleischer paper, entitled "Two and Twenty: Taxing Partnership Profits In Private Equity Funds," discusses several possible alternatives to the current system. In addition to treating carried interest allocations as ordinary income regardless of the underlying character of the fund's income, the paper suggests eliminating deferral by requiring realization at the time that carried interests are received (notwithstanding valuation issues) or imposing a cost of capital charge on managers (as if interest on a deemed loan from the fund limited partners or members to the managers is periodically forgiven). It is possible that interests received by a manager in exchange for capital contributions (i.e., capital interests) would be excluded from any special treatment that applies to carried interests, although this would obviously depend on the shape the legislation ultimately takes.

Although the focus on carried interest taxation appears to have been inspired by the more general focus on hedge funds, the tax changes being considered would affect other types of investment funds and potentially any partnership (or entity treated as a partnership for federal tax purposes) that issues a profits interest including UPREITs and DownREITs. It is also not clear what collateral tax consequences these changes might have. For example, capital gains allocated to an individual manager generally are not subject to self-employment tax under current law; this might change if these allocations are treated as ordinary income.

Please let us know if you would like us to monitor developments, to keep you apprised if the Congressional tax committees prepare to take up specific legislation in this area. Lawyers in our Washington, D.C., office, including former counsels on the Senate Finance Committee and the House Ways and Means Committee, closely follow the work of those committees. Please contact your K&L Gates relationship partner or one of the authors of this alert, whose phone numbers are listed on the front page.

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