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Tax rate increase may impact carried interest provisions

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Many real estate ventures have a carried interest, often known as a promote structure, in the allocations for the venture sponsor. A carried interest is an interest in the gain realized upon disposition of the property. The carried interest often rewards the venture sponsor for the risks during the development of the property.

Congress has been considering treating this type of allocation as compensation to the sponsor which would be taxable at ordinary income rates rather than an allocation of gain from the sale of the property which would be taxable at lower capital gain rates. Congress has considered converting the capital gain treatment of the carried interest paid to private equity and hedge fund managers with similar allocation structures. However, the proposed legislation included all partnerships and LLCs and therefore would have covered all investment ventures with a carried interest structure including real estate ventures.

This legislation was not passed in 2010 but is likely to be proposed again in 2011 and may have a January 1st, 2011 effective date.

As the real estate markets begin to stabilize, sponsors and investors may be considering selective dispositions, especially given the expectation of rising income tax rates combined with the carried interest proposal. If the Bush-era tax cuts expire, as scheduled, the highest ordinary income tax rate would increase from 35% to 39.6% which would compound the effect of a change in the carried interest statute.

For sponsors of ventures with these carried interest provisions, the motivation to sell will be significantly greater as the 15% long term capital gains tax rate will be available for any gains realized in 2010.

Dispositions in 2011 could trigger taxes at 39.6% on the same gain allocation if the carried interest proposal is passed. Sponsors should review their current portfolio of properties, review the venture agreements to determine the allocation of the gain on sale and consult their tax advisors to identify opportunities before December 31st.

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