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PROPER TAXATION OF THE PROMOTE IN A REAL ESTATE PARTNERSHIP ("CARRIED INTEREST")

INTRODUCTION AND BACKGROUND

The Promote structure is widely used by real estate partnerships as a way to share profits between general and limited partners and as a means to ensure that the interests of the general partner are aligned with the interests of the limited partner investors. It is recognized as a rational way to distribute the long-term capital gain upon the sale of a property. Under the Promote structure, the limited partners grant the general partner a share of the profits that is more than proportional to his or her investment of capital in return for the general partner's entrepreneurial activities and the additional risks he or she bears, as described below. When the profits received by both limited and general partners are of a capital nature (i.e., capital gains from the sale of an appreciated property), those profits are taxed as capital gains rather than as regular income.

It is estimated that over $1.3 trillion is invested in real estate through partnerships and that the majority of these partnerships use a Promote structure. For instance, one recent analysis of the apartment communities developed in Los Angeles County in 2008 shows that more than half were built by partnerships using a Promote structure.

Unfortunately, the Promote structure could become collateral damage in policymakers' attempts to rein in Wall Street hedge fund asset managers. Congress and the Obama Administration are considering taxing Wall Street "carried interest" as ordinary income rather than as a capital gain.

However, the term "carried interest" is defined so broadly in the proposed legislation that the Promote structure used by real estate partnerships would also be subjected to a tax increase in excess of 150 percent. Such a change would have devastating effects on the commercial real estate industry, would dampen investment in the apartment industry and would worsen the nation's shortage of affordable housing.

CURRENT TAX TREATMENT AND PROPOSED TAX TREATMENT OF THE PROMOTE

Current tax law treats general partners and limited partners equally in determining whether their profits are ordinary income or capital gains. If the profits received by either a general partner or a limited partner are of an ordinary nature (e.g., operating income), they are taxed as ordinary income to all partners. If the profits generated by the partnership are of a capital nature (e.g., capital gains from the sale of an appreciated property), they are taxed as capital gains to all partners. This is the appropriate tax treatment under long-standing tax law.

However, the "carried interest" proposal currently being considered would not only dramatically increase the tax rate on the Promote, it would also create a bifurcated tax system that taxes the capital gains profits realized by the general partner differently than the capital gains profits realized by the limited partners. Under the proposal, any portion of the Promote attributable to capital gains and realized by the general partner would be taxed as ordinary income (currently as high as 35 percent; 39.6 percent after 2010), but the share of those same profits received by the limited partners would continue to be taxed at the lower 15 percent capital gains tax rate. Additionally, the proposal would subject the Promote to self-employment taxes (generally, an additional 2.9 percent). As a result, general partners would see their effective tax rate on their portion of the Promote increase from the 15 percent capital gains tax rate to 37.9 percent (42.5 percent after 2010).

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THE PROMOTE IS RETURN FOR RISK; NOT COMPENSATION FOR SERVICES

The Promote is not compensation for the general partner; it is a return on the risk they undertake. **To argue that a general partner in a commercial real estate transaction acts merely as an "employee" and should be treated as an employee for tax purposes ignores the nature of the general partner's role in the transaction.**

The general partner assumes entrepreneurial risks that the passive limited partner investors are not willing to accept (and often, such as in the case of pension and other institutional investors, are not permitted to accept). In addition, the general partner has often agreed to subordinate his or her return (sometimes even including return on his or her invested capital) to the return of the limited partners. In exchange for this, the general partner receives an increased share of any entrepreneurial gains that may be generated.

- **Risk of Loss.** A general partner is at risk of losing more than just his or her initial investment because the general partner is the ultimate guarantor of the transaction. This is in contrast to the limited partners, whose liability is limited only to the potential loss of their investment capital (thus, the term "limited partner"). These risks assumed by the general partner manifest at a number of points throughout the development process:
    - Assumption of project identification and pre-construction/rehabilitation expenses
    - Recourse construction/rehabilitation loan (the borrower is personally responsible for a portion of debt)
    - Construction/rehabilitation cost overrun guarantees
    - Refinancing (to obtain permanent financing) risk
    - Environmental remediation

- **Subordinated Return.** The limited partners receive both a return of their initial investment and a priority return thereon before the general partner receives any Promote interest. In addition to the general real estate investment risk that the development may not produce any profit (which is assumed to some degree by all investors), the general partner takes on the additional risk that any profit generated may only be sufficient to provide the priority return and a return of capital to the limited partners—leaving no Promote interest for the general partner. It is also possible that the general partner will agree to subordinate the various arm's-length negotiated fees (management, construction, etc.) that he or she often receives as compensation for services performed for the partnership. If/when these fees are received, they are taxed as ordinary income to the general partner.

IMPACT OF PROPOSED CHANGE ON APARTMENT INVESTMENT AND AFFORDABLE HOUSING

The carried interest proposals under consideration by Congress would increase taxation of the Promote portion of a real estate partnership by more than 150 percent. Faced with such a dramatic tax increase, it is likely that many real estate developments will fail to produce enough profit to adequately compensate the entrepreneurial general partner for the risk he or she is being asked to undertake.

Additionally, these tax increase proposals would have the perverse result of encouraging real estate entrepreneurs to favor taking on more debt over equity investments. Under the proposal, any capital gain that an entrepreneur realizes from a project with 90 percent debt financing would be taxed as capital gains, but any capital gain that an entrepreneur realizes from a project with 90 percent equity financing and a Promote structure would be taxed at ordinary income tax rates—more than doubling the tax rate.

These proposals will have a substantial negative impact on new apartment construction and the rehabilitation of older properties because under these changes, the general partner will not realize a large enough after-tax profit to justify taking on the substantial risks associated with these deals.

The result will likely be that many apartment communities, particularly those providing moderately priced rents, that might have been developed or renovated under the current tax laws would not be undertaken under the proposed new tax law because they would become economically unattractive to the general partner. In other cases, apartment communities may be developed or renovated but rents will have to be higher for the project to be economically attractive on an after-tax basis. In both cases, the result is fewer apartments at less affordable rents—a situation that would worsen the increasingly serious affordable housing crisis.

Updated: September 9, 2009