NMHC NATIONAL MULTIFAMILY HOUSING COUNCIL

NAA NATIONAL APARTMENT ASSOCIATION

CARRIED INTEREST

NMHC/NAA Viewpoint

NMHC/NAA believe that carried interest should be treated as a long-term capital gain if the underlying asset is held for at least one year. The industry strongly opposed extending the holding period to three years as part of tax reform legislation enacted in 2017 but notes that final regulations released in January 2021 exclude Section 1231 gains from the extended holding period.

Real estate companies account for 50.8 percent of all partnerships.

Real estate development carries considerable financial risks. In fact, one in 10 multifamily projects never breaks ground. Because of the risks involved, many real estate partnerships use "carried interest" to encourage innovation and entrepreneurship.

Also called a "promote," carried interest has been a fundamental part of real estate investment partnerships for decades. Managing partners receive a carried interest, or a share of profits once an asset is sold, in recognition of both the value they bring to the venture and the risks they take. In addition to their management expertise, managing partners often make initial capital contributions to the venture and assume responsibility for recourse debt, litigation risks and cost overruns, among other risks.

Current tax law treats carried interest as a long-term capital gain if the underlying asset is held for at least three years. The multifamily industry believes a one-year holding period is the appropriate tax treatment of carried interest. NMHC/NAA strongly opposed extending the one-year hold period to three years as part of tax reform legislation enacted in 2017 but notes that final regulations released in January 2021 exclude Section 1231 gains from the extended holding period.

Carried interest should receive capital gains tax treatment because it represents a return on an underlying, long-term capital asset, as well as risk and entrepreneurial activity. This is in contrast to any fees that managing partners receive in payment for operations and management activities, which are taxed as ordinary income.

Some political forces would like to unfairly tax carried interest at ordinary income rates regardless of how long an asset is held. Such a change would adversely affect not only the apartment industry, but also the entire real estate industry, given that 50.8 percent of all partnerships are real-estate related.

A higher tax rate on long-term capital gains will discourage real estate partnerships from investing in new construction at a time when demand for apartments continues to grow and chronic underbuilding has limited new housing supply. In fact, research commissioned by NMHC/NAA shows that the nation will need to build 328,000 new apartments each year through 2030, a mark reached just four times since 1989.

Finally, some in Congress see the tax revenue generated by the carried interest proposal as a way to offset the cost of other tax changes. However, smart tax policy demands that each tax proposal be judged on its individual merits.