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Proposed Tax Changes Would Impact Real Estate Partnerships
By Erika Morphy

Washington, DC—Congress is considering changing the way certain private equity transactions are taxed--specifically, changing the tax characterization of carried interest. Carried interest is the percentage of profits from a fund, JV or limited partnership that a general partner takes as compensation. Management fees are also part of the compensation. However, that is classified as ordinary income.

The impetus, of course, has been the perception that because services income is being taxed at capital gains rates (15%) as opposed to ordinary income (which can be as much as 35%), these investors are realizing a huge--and unfair, so the theory goes--windfall. Changes in proposed legislation would basically treat income received by partners for performing investment management services as ordinary income.

Obviously, private equity investors would be affected. But some attorneys say the change would also have a huge impact on real estate partnerships and joint ventures. "There has not been much attention paid to the affect this change in law would have on real estate partnerships, even though 46% of partnership returns are filed by the real estate industry," William R. Ahern, an Orange County, CA-based partner with Allen Matkins, says.

If the bill were to become a law, its impact would be a double whammy for the industry because few right now appear to be watching the issue. "I work with a lot of real estate companies and I am not sure if the average real estate company is aware of this issue," says Len Nannarone, a partner at Mintz Levin Cohn Ferris Glovsky and Popeo PC. For right now, he says, most see it as a separate issue for private equity transactions.

Yet the impact on real estate partnerships and JVs--which, of course, are ubiquitous in the industry--would be huge. "In the real estate industry, it is common for a developer to get carried interest," Ahern explains. "It is given to him or her as consideration in finding the deal and seeing it completed from start to finish. If a bill like this is enacted, it will affect their returns and might prevent them from undertaking certain projects with a lot of associated risk."

All of the press seems to be focused on what could happen to the private equity funds, William H. Venema, chair in the corporate and securities practice of Epstein Becker Green Wickliff & Hall PC and the managing partner of the Dallas office, notes. "But if you read what Congress is saying it is clear that they see no reason why this legislation should differentiate between a private equity fund or a JV between a real estate developer and financier," he explains.

When the legislation was first introduced, Venema was not too worried because it was almost certain to be vetoed by the president. Last week, though, he heard of a compromise bill being proposed that would link private equity tax changes to alternative minimum tax relief for the millions of taxpayers who get hit with it. Senator Chuck Grassley (R-IA) says he plans to link his Blackstone bill to AMT relief. Rep. Charles Rangel (D-NY) says the same thing for the more sweeping carried-interest tax bill that Rep. Sandy Levin (D-MI) introduced in June.

"The compromise could prove to be a smart move by proponents of the carried-interest tax bill. Members of both parties believe that the AMT needs to be revised this year, although not repealed. Millions of wealthy people who pay AMT comprise a fairly large voting block," Venema says.

President Bush will probably still veto it, Venema expects, although the new proposal will likely go further than the old. "This is one of those stand-by-for-further-development situations," he adds.

Charlie Temkin, a Washington, DC-based director at Deloitte Tax LLP, thinks these measures have a 50-50 shot of becoming law. Members of the Senate Finance Committee still have a noncommittal attitude towards the change, he says. "They are still trying to figure it out and understand what the affects would be." Still, though, there are compelling reasons for Congress to consider every way to raise revenue now, he says, adding, "And this particular issue has been characterized as closing a loophole for the wealthy, which would make it easier to pass."

Ultimately, Temkin says, if the legislation were to pass, tax professionals would find a way to mitigate the impact. "Whenever changes as fundamental as this are made into the tax code a lot of technical questions are raised. It is impossible to get everything right the first time. There will be unintended consequences and therefore planning opportunities as well. It is tough to know what is going to happen, but it would likely be the case that there will be a certain amount of deal restructuring that would at least minimize the impact of the legislation."