Carried Interest Bill — Impact on Real Estate Partnerships

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This article discusses the practical impact of carried interest legislation on real estate partnerships if enacted in the form currently proposed. This legislation would do far more than deny capital gains rates to service providers; it would also change fundamental deal dynamics and structuring for real estate partnerships.

A. Introduction

Fighting abuse is on the minds of lawmakers. Compensation structures in the financial sector have come under increasing scrutiny. There has been a public perception that many mainstream compensation structures are abusive. In some instances this perception is based on reality. However, coupled with an overwhelming need to raise revenues, the response can lead to the unintended consequences of legislative caprice and economic carnage, as exemplified by recently proposed carried interest legislation.

Proposed section 710 would in one broad stroke dramatically worsen the tax treatment of most forms of investment partnerships. Although this legislation originally targeted specific compensation structures employed in hedge funds and private equity funds, the current proposals would apply equally to traditional real estate investment partnerships. If enacted as currently drafted, it could seriously impede real estate investment and development activity that is essential to long-term growth and capital formation in our economy. It may also disrupt many existing arrangements and thus have a significant retroactive impact.

The purported justification for the law is to deny capital gains treatment to managers of investment partnerships who perform the specified services. The legislation would tax far more than compensation for services, however. Income could be treated as ordinary rather than capital even when no services are performed by the taxpayer, such as when advice has been provided by an affiliate. Also, while there is an exception to ordinary income treatment for so-called qualified capital interests, the exception is deceptively narrow.

Note that the effect of ordinary income treatment can be amplified when, as is often the case, there exist liabilities in excess of basis at the partnership level, or ''negative capital'' accounts of the holder of an investment services partnership interest, because there will be significant phantom income on a disposition of the interest to the extent proceeds are used to satisfy the indebtedness. Historically, this phantom income is ameliorated as a result of the basis step-up that occurs at death under section 1014 (assuming that it is reinstated). It appears that if section 710 is enacted in its current form, the basis step-up will no longer be available to the holder of an investment services partnership interest.

Moreover, it seems that returns on invested capital of managers and their affiliates can be swept into the ordinary income regime. The legislation would also limit managers' ability to deduct tax losses, and it would penalize those who receive refinancing distributions.

This ordinary income treatment could be foisted on owners of partnerships when there are no carried interests. For example, if an affiliate of a partner performs management or advisory services, ordinary income can result to the entire partnership — even partners who perform no services and who invest capital for a straight partnership percentage. The typical family-owned, family-operated real estate partnership with no outside investors would be caught in this web and denied capital gains treatment.

These are among the many adverse tax consequences that will be discussed in this article, along with some suggested practical techniques that may be helpful for surviving the ''perfect storm'' that threatens real estate ventures under proposed section 710.

B. Partnership Profits Interest: An Unruly Beast

Well-intended legislative overreactions abound. One example is the enactment of section 409A,[1] which imposed an entirely new highly complex regime on arrangements that fall under the broad category of

[1]Section 409A was added to the code, effective January 1, 2005, under section 885 of the American Jobs Creation Act of 2004. Section 409A regulates the tax treatment of nonqualified deferred compensation, whether paid to executives or any other employees. The effects of section 409A are far-reaching, because of the exceptionally broad definition of deferral of compensation. Section 409A was enacted partly as a response to the practice of Enron executives accelerating the payments under their deferred compensation plans to access the money before the company went bankrupt. *See generally* Joint Committee on Taxation, ''Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations'' (Feb. 2003), *Doc 2003-4185, 2003 TNT 34-35*.

The IRS issued initial guidance on December 20, 2004, in the form of Notice 2005-1, 2005-1 C.B. 274, *Doc 2005-435, 2005 TNT 4-7*, which established various interim rules and definitions, and

(Footnote continued on next page.)

nonqualified deferred compensation. This regime mainly prevents deferral of compensation and thus affects the timing of income recognition.

Section 409A was enacted in response to alleged bad behavior by Enron executives. However, it now applies in virtually every business context. It is onerous. It restricts business behavior and is a trap for the unwary. While it has taken nearly five years to implement the statute generally, development of cohesive administrative guidance on how this provision applies to compensation structures involving grants of partnership profits interests has yet to appear.[2]

The proposed carried interest legislation threatens to have an even greater impact on partnership structures than section 409A. To limit a relatively narrow category of potentially abusive partnership compensation structures, the proposal threatens to damage partnerships' ability to serve as effective and efficient vehicles for employing capital by real estate and other types of investment partnerships.

The taxation of partnership compensation structures has been one of the most difficult areas for the government to develop a comprehensive and intellectually pure set of strictures.[3] The taxation of grants of partnership profits interests, which are often integral to real estate partnership structures, has posed difficult administrative and conceptual difficulties for at least four decades.[4] The most recent administrative attempt at regulation came in 2005 and has largely stalled.[5]

There are good reasons the attempts to regulate this area have failed so far. Although the system does allow some arrangements to escape current taxation (and ordinary income treatment), it works relatively well and is likely a major contributing factor to many types of economic agreements that should be encouraged.

The most recent proposed carried interest legislation would resolve many of the open questions regarding the taxation of partnership profits interests. However, it would do so by significantly worsening the tax treatment of these interests and making them far less desirable. It would also include within its broad scope other noncompensatory partnership structures that reflect the different risk-sharing arrangements that are usually necessary to unite opportunities with investment capital. For example, if the investors or "money partners" receive a preferred return, that could cause the partner who identifies and contributes the opportunity to fall within the wholly undesirable net of proposed section 710.

Moreover, what has received little or no attention is that this legislation may apply to self-managed real estate partnerships even when there are no carried interests employed. So if all the partners are both money partners and service providers (directly or through affiliates), proposed section 710 would impose ordinary income treatment and other undesirable tax consequences (such as the inability to deduct losses) even when all the partners share profits and losses on a strictly proportionate basis. This aspect of the legislation will be discussed in greater depth below.

C. Historical Use of Partnerships in Real Estate

Partnership structures under subchapter K have historically provided an ideal medium to embody complex economic relationships that reflect different types of contributions made by the partners, the varying risk tolerance among partners, and the opportunity to share profits in a manner that takes into account these individual partner traits. Yet partnership structures can work with minimal friction and resistance caused by tax consequences. As passthrough entities not subject to two tiers of taxation like a C corporation and not subject to the statutory restrictions applicable to S corporations (such as the one-class-of-stock requirement), partnerships (and limited liability companies taxed as partnerships) have occupied a central role in the world of real estate dealmaking. Also, the partnership form of entity provides unique flexibility in structuring economic arrangements and allocating risks and rewards.

If enacted, the proposed carried interest legislation could greatly restrict the ability of partnership structures to flourish as they have in the past.

D. The Tax Extenders Bill of 2009

On December 9, 2009, the House passed, by a 241-181 vote, the Tax Extenders Act of 2009 (H.R. 4213), which was introduced by Ways and Means Committee Chair Charles B. Rangel, D-N.Y. The extenders bill has received

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provided for a standard of "reasonable good-faith compliance" to apply until the regulations were published. Long-awaited final regulations were published on April 17, 2007. The IRS has since issued Notice 2007-86, 2007-46 IRB 990, *Doc 2007-23546*, *2007 TNT 205-10*, which provided that the final regulations would become effective (and the reasonable good-faith compliance standard would expire) on January 1, 2009. Guidance has yet to be issued on the treatment of partnership arrangements such as profits interests under section 409A.

[2]The regulations indicate that the standard section 409A rules apply to partnerships. However, the final regulations reserve guidance on the specifics of how these rules apply to partnerships and limited liability companies. Pending further guidance, the rules on stock rights apply to grants of profits interests, other partnership interests, and options on partnership interests.

[3]*See generally* Breitstone and Berra, *Practical Drafting Considerations for Partnership Agreements and Operating Agreements in the Closely Held Context*, New York University, 66th Institute on Federal Taxation, Chapter 8 (2008).

[4]See the notorious case of *Sol Diamond v. Commissioner*, 56 T.C. 530 (1971), *aff'd*, 492 F.2d 286 (1974), which related to the 1961 and 1962 tax years.

[5]In 2005, when the proposed section 83 regulations were introduced, Treasury also issued a proposed revenue procedure that would make Rev. Proc. 93-27, 1993-24 IRB 1, *Doc 93-6562*, *93 TNT 123-7*; and Rev. Proc. 2001-43, 2001-34 IRB 1, *Doc 2001-20855*, *2001 TNT 150-11*, obsolete on finalization of the regulations (see Notice 2005-43, 2005-1 C.B. 1221, *Doc 2005-11236*, *2005 TNT 98-37*). The new rules would apply to grants of compensatory profits interests issued on or after the date of the final regulations. As of this writing, the final regulations have not been issued and it appears that they are neither imminent nor likely to resemble the proposed regs.

(Footnote continued in next column.)

An in-depth discussion of past and present law governing the taxation of partnership interests is set forth in Breitstone and Berra, *supra* note 4.

a statement of support from the Office of Management and Budget. The bill includes a version of the carried interest provisions that is similar, but not identical, to the version proposed earlier in the year by Rep. Sander M. Levin, D-Mich., in H.R. 1935. It should be noted that these proposals differ materially from President Obama's initial budget proposal for taxing service partnerships.

The House extenders bill would create a new section 710 that would drastically alter the historical taxation of partnership profits interests and other interests granted to a provider of specific services to the partnership (or an LLC taxed as a partnership). As described in greater detail below, proposed section 710 would deny capital gains tax rates to the holder of such an interest unless the interest does not differ in terms from interests held by non-service-providers or mere investors.

The original targets of the legislation were arrangements involving partnerships and LLCs designed to give investment fund managers a share of profits that would be taxed as capital gains in lieu of what would otherwise be paid as management fees and performance-based compensation taxable at ordinary income rates. The targeted partner is typically a mere service provider who is managing other people's money. These service providers have been said to have "no skin in the game," and thus it is contended their profits should be taxed as ordinary compensation income.

E. Proposed Section 710: The Specifics

Under proposed section 710, if a partnership interest constitutes an "investment services partnership interest" within the meaning of proposed section 710(c), all profits from that interest generally will be taxed as ordinary compensation income. An interest is an investment services partnership interest if it is held by any person if it was reasonably expected (at the time that such person acquired such interest) that such person (or any person related to such person) would provide (directly or indirectly) a substantial quantity of any of the following services:

- advising on the advisability of investing in, purchasing, or selling any specific asset;
- managing, acquiring, or disposing of any specified asset;
- arranging financing with respect to acquiring specified assets; or
- any activity in support of any service described in the above subparagraphs.

Section 710(c) defines specified assets as securities, real estate held for rental or investment, interests in partnerships, commodities, or options or derivative contracts in connection with any of these.

The House extenders bill provides a meaningful exception for capital invested in the venture by the service provider. Ironically, it appears that this exception may not be available in many partnerships where no carried interest is employed.

The qualified capital interest exception provides that items of income, gain, loss, and deduction that are allocated to an investment services partnership interest are not recharacterized as ordinary compensation income if:

- allocations of items are made by the partnership to such qualified capital interest in the same manner as such allocations are made to other qualified capital interests held by unrelated partners who do not provide any services; and
- the allocations to the unrelated partners are "significant."

The qualified capital interest exception under the House extenders bill provides for a "cliff" effect and is excessively narrow. If, for example, the holder of what would otherwise be a qualified capital interest is a partner who also manages the investment (or is an affiliate of a manager) and agrees to subordinate a return of his capital to that of another investor, the qualified capital interest exception would not be applicable to that holder. This is true even if the holder provides no management services whatsoever.

As proposed, the qualified capital interest exception may be inapplicable even if the partnership does not contain carried interests within its capital structure. For the qualified capital interest exemption to apply to an interest held by a service provider (or affiliate), there must also be a like qualified capital interest held by a partner who is unaffiliated with any service provider, and the allocations to the unaffiliated party must be significant. Thus, in a partnership structure that employs strictly proportional or "straight up" partnership interests in which profits interests are granted proportionally to capital contributed, if all the partners are affiliated within the statutory definition and an affiliate provides any of the specified services, the qualified capital interest exemption would not be applicable. For example, for a family-owned real estate partnership in which someone in the group provides any of the specified services (a virtual certainty), ordinary income treatment and the other adverse tax consequences of section 710 may be applicable. This is because there may be no investor who holds a qualified capital interest and is "unrelated."

Likewise, even outside the family business context, partners may be affiliated solely by common ownership of business entities that can take on a variety of forms. It is unlikely that the drafters of the legislation intended that the ordinary income, loss disallowance, and other adverse tax consequences of proposed section 710 may be applicable when there are no carried interests.

Note that one of the few differences between the House extenders bill and the Levin bill is that under the House bill, section 710(c)(2)(B) was added to grant authority to address the situation in which there is not significant income allocable to a qualified capital interest of an unaffiliated party under regulations or other administrative pronouncements.

The Joint Committee on Taxation explanation at p. 181 of the blue book contains the following encouraging language:

> A special rule applies in the case of no or insignificant partnership allocations to unrelated nonservice providers. The special rule applies, to the extent provided in Treasury guidance, in any case in which allocations to unrelated nonservice providers' qualified capital interests are not significant

> compared to allocations made to the service provider's qualified capital interest. Under the special rule, partnership items of income, gain, loss, and deduction are not recharacterized as ordinary under the general rule of the provision, to the extent the items are properly allocable to the qualified capital interests as provided in the Treasury guidance.
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> For example, it would be appropriate for Treasury guidance to implement the special rule in the case in which all of the partners of the partnership are service providers, so there are no unrelated nonservice providers. It is anticipated that Treasury guidance may provide that pro rata allocation of partnership items to qualified capital interests generally satisfies the special rule in this situation. It is anticipated that the Treasury guidance will take into account whether the partnership agreement provides for proper allocation of the items among the partners and, with respect to a service provider, as between the partner's qualified capital interest and the remainder of the partner's interest in the partnership.

This language would seem to exempt qualified capital interests held by service partners when there are no unrelated holders. However, it is difficult to imagine that regulations would adequately address this concern. The easy case would be when all allocations were straight up and there are no carried interests. However, in the real world that is seldom the case. Disproportionate capital contributions and allocations will, in the absence of an unrelated party to measure whether the interest is attributed to services or capital, put the Service in the unfortunate position of having to make value judgments. Such a grant of regulatory authority would likely be unadministrable. This point is illustrated by the following statement in the blue book:

> Items allocated among the partners in proportion to each partner's qualified capital may be considered as allocated in the same manner, under this rule, if the qualified capital interests to which the allocations are made are substantially identical as to the degree of risk and with respect to all other economically significant aspects, benefits and burdens. For example, items are not allocated in the same manner under this rule if they are allocated in the same proportion to riskier interests and to safer interests. Similarly, items are not considered as allocated in the same manner under this rule if allocations to qualified capital interests of nonservice providing partners are artificially high while returns that are below market, or artificially low, are made to other types of interests (for example, debt) held by the nonservice providing partners.

My guess is that regulations granting the Service the authority to make such determinations will be a long time coming.

Section 710(c)(3) provides that parties will be considered as related if the relationship would result in disallowance of losses under section 267 or section 707(b). Section 710(e) of the House extenders bill also grants regulatory authority to provide that persons will not be treated as related for purposes of section 710. Presumably, the drafters were aware that section 710 could tax a nonservice provider solely by reason of these attribution rules. However, it is questionable whether a broad grant of regulatory authority is the appropriate way to address this and the numerous other technical gaps and profound conceptual difficulties that this legislation presents.

F. Section 710: Examples

Section 710 would apply to the very commonly used structure in which profits are shared one way before a return of investor capital and then another way afterward. Typically, the investor group expects a priority return of capital, and frequently a hurdle rate of return before the carried interest percentages will be applicable. Once those priorities are paid, the profit- and loss-sharing ratios typically shift so that the investors who provided the opportunity and who may play a role in the venture will get a share of profits greater than their percentage share of capital. This larger back-end percentage of profits is typically referred to as the carried interest.

Example 1: Partnership AB is formed with A contributing $90 and B contributing $10 of initial capital. B manages the business of the partnership. The agreement provides that all profits and distributions will be made in proportion to invested capital (that is, 90/10) until invested capital has been returned plus a 5 percent rate of return. Thereafter, profits will be shared fifty-fifty. Assuming B holds an investment services partnership interest, B will be subject to section 710 on his carried interest. His preferred interest, based on the $10 capital contribution, and the preferred rate of return, but not his 50 percent share of the back-end profits, will constitute a qualified capital interest.

Example 1 illustrates a typical traditional partnership structure with a carried interest. Proposed section 710 would cause the person who manages the business of the partnership to be taxed at ordinary income rates on all of his income from the partnership subject only to the qualified capital interest exception. Note that this conclusion would not change if B is fully compensated for the management services he provides through an arm's-length fee. That he provides some services taints all of his income except to the extent that income is derived from a qualified capital interest.

Example 2 provides a slightly different fact pattern with a significantly different outcome.

Example 2: Partnership AB is formed with A contributing $60 and B contributing $40 of initial capital. B manages the business of the partnership. A, an institutional investor, is risk averse. B, a real estate entrepreneur, is more familiar with the real estate business and this project in particular. He is thus willing to subordinate a return of his initial capital in exchange for a greater carried interest. Thus, the partnership agreement provides that all profits and distributions will be made first to A until A's invested capital is returned plus a 5 percent rate of return, and then to B until B's invested capital is returned plus a 5 percent rate of return. Thereafter, profits will be shared fifty-fifty. Assuming B holds an investment services partnership interest, B will be subject to section 710 on both his preferred interest and his carried interest.

Under the facts of Example 2, B will be denied capital gains treatment for this project in its entirety. This would be so even if B were compensated for any services he performed on arm's-length terms.

Assuming B was the party who created or identified the opportunity, he could choose how to capitalize the venture. Thus, B could avoid the harsh tax treatment afforded to him under proposed section 710 by either providing no services whatsoever to the partnership (not practical or advisable) or by not using a partnership structure and instead putting up all of the capital to fund the venture with his own funds or with borrowed funds. Thus, proposed section 710 provides a significant disincentive to real estate ventures to attract investor capital. It also provides an incentive to use excess leverage rather than equity. Lastly, it penalizes hands-on investing.

In addition to the foregoing, proposed section 710 would cause numerous unintended consequences to many typical real estate partnerships. For example, assuming the estate tax and the unlimited basis step-up upon death under section 1014 are reinstated, it appears that the recharacterization of partnership gains as compensation income could result in a denial of the basis step-up on the death of the real estate entrepreneur. This would result from the potential application of the rules governing the tax treatment of items of compensation after the death of a service provider. Such postdeath compensation is not entitled to a basis step-up since it would constitute income in respect of a decedent under section 691. When applied to interests in leveraged real estate partnerships that frequently have liabilities in excess of basis (referred to as negative capital accounts), this proposed legislation could have a devastating tax effect on the estates and heirs of successful real estate entrepreneurs.[6]

G. The Obama Budget Proposal

The Obama budget also proposes carried interest reform and it appears to take a different tack than the House extenders bill. The budget proposal would apply to all partnership profits interests received by a service provider. Unlike the House extenders bill, which applies only to specified types of partnership activities, Obama's budget proposal is somewhat broader in scope. Yet it does contain some potentially encouraging language. The proposal states that "to the extent that a partner who holds a [services partnership interest] contributes 'invested capital' and the partnership reasonably allocates its income and loss between such invested capital and the remaining interest, income attributable to the invested capital would not be recharacterized."[7] This language seems to reject the cliff effect in the House extenders bill for qualified capital interests. While the budget proposals seem to conclude that a mere profits interest received by a partner who performs services but does not contribute capital will be subject to ordinary income treatment in its entirety — a significant departure from current law — it leaves open the possibility that if both services and investment capital are contributed to a venture, the holder may be entitled to capital gains treatment if there is a reasonable allocation between the services portion and the investment portion. While the House extenders bill also contemplates a mixed approach, as drafted it still does not permit reasonable allocations to reflect different risk sharing within a partnership when different investment partners agree to bear different levels of risk. This point is illustrated in Example 2 above.

The administration's proposal seems to treat all income derived from the mere grant of a purely profits interest for services as ordinary compensation income. However, if the service provider also contributes capital, a hybrid approach is allowed even if the service provider also receives a carried interest. The administration's proposal appears to be better thought out — even though it is unclear what constitutes a reasonable allocation between the services and the investment capital components. It is hopeful that when and if the administration's proposal is reduced to actual language these meritorious aspects will be reflected.

H. Practical Considerations

Assuming that some version of the carried interest legislation resembling the House extenders bill is enacted, there will be a number of planning issues that must be addressed in connection with existing and newly created real estate partnerships. The remainder of this article will address some of the possibilities.

While the proposed carried interest legislation does not reflect current reality, the possibility of enactment is certainly on the minds of the better informed drafters of partnership agreements. The use of carried interest structures remains prevalent; however, drafting an agreement today without provision for the possibility that some form of this legislation will be enacted may, with the benefit of hindsight, prove to be deficient.

I. Conflict of Interests

1. Dispositions. The economics to the recipient of the carried interest can be so drastically altered by this legislation that it may change economic behavior. In fact, a conflict of interest may be created between the holder of the carried interest and the mere investor partners. For example, under current law, both the investor and the managing partner would be subject to the same rates of tax on the disposition of the property. After enactment of proposed section 710, that would no longer be the case. The difference between capital gains rates paid by the investor and ordinary income rates paid by the managing partner could be 20 percent at current rates. For example, if the property has liabilities in excess of basis, it is possible that the investor would have positive after-tax cash proceeds from the venture while the managing partner would have negative after-tax proceeds. The manager may have to come out-of-pocket just to pay the taxes on the disposition. The investor may want to sell and cash out, while the manager would not. Perhaps even stranger, what if the manager bought out the investor partner so that the manager held all the interests

[6] *See generally* Breitstone, "Carried Interest Bill — a 'Death Trap' for Real Estate Partnerships," *Tax Notes*, June 22, 2009, p. 1459, *Doc 2009-12548*, or *2009 TNT 118-8*.

[7] "General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals" (the green book), *Doc 2009-10664, 2009 TNT 89-44* at 23.

in the venture? Would the manager thus fall outside the reach of section 710 since, rather than having a carried interest, he would hold all of the interests?

Perhaps the existence of this potential conflict can be addressed in the drafting of an agreement. Under current law it is atypical for the mere investor partners to be able to initiate a disposition. In representing a money partner, it may now become imperative to insist on greater controls over dispositions.

Note that there is an interesting and somewhat disturbing dichotomy posed by this legislation. The phenomenon of liabilities in excess of basis typically results from either refinancing distributions or losses in excess of contributed equity. For the holder of an investment services partnership interest, losses in excess of contributed capital are generally suspended. Also, as discussed in the following section, the likelihood of receiving refinancing proceeds without tax consequences is greatly curtailed by proposed section 710. Together, these features tend to limit the possibilities of generating negative capital accounts or liabilities in excess of basis. It seems incongruous that preexisting arrangements would not be grandfathered and would be forced into an even worse tax dynamic than newly created arrangements under this legislation. Existing arrangements are forced into a worse dynamic since the tax consequences of a disposition with liabilities in excess of basis are greatly amplified. For the holder of the investment services partnership interest, new arrangements are unlikely to suffer from this amplification since they will not likely have liabilities in excess of basis.

2. Refinancings. A conflict of interest may exist between the real estate entrepreneur who will be subject to section 710 and the investor partners who will not. The investor partners will expect to have the ability to receive tax-deferred refinancing distributions while the entrepreneur may not be willing to allow that.

The language of proposed section 710 under the House extenders bill poses a significant disincentive to make refinancing distributions in return of capital and unrealized appreciation. Section 710(c)(2)(C) contemplates that a partner's qualified capital interest will be reduced by some items such as losses and distributions. Thus, if the holder of a qualified capital interest receives a return of capital and more through refinancing distributions, the qualified capital interest is reduced. This seems to mean that if the capital account of the holder of an investment services partnership interest is reduced to zero, even to the extent of the qualified capital interest, the entire interest of that partner will be subject to proposed section 710. The qualified capital interest is thus reduced or eliminated. On the basis of this overall scheme, it appears to be a drafting error in the House extenders bill that distributions in excess of that amount would not be taxable as ordinary income. If it is not taxable at the time of distribution, there is little doubt it will be taxable at ordinary income rates at the time of disposition of the property, whether by the holder or his heirs.[8] Perhaps that is a matter that will be addressed under the broad grant of regulatory authority of section 710(e).

Thus, it is unclear whether the long-standing technique of refinancing real estate to distribute appreciation on a tax-deferred basis will have continued viability after the enactment of proposed section 710. The ability of appreciation to be extracted from a real estate venture on a tax-deferred basis by refinancing the property and distributing the proceeds to the partners may be greatly impaired. Many real estate partnerships continue almost in perpetuity by periodically refinancing and pulling out proceeds at regular intervals as appreciation in the real estate markets supports this behavior. These cash proceeds provide a fertile source of capital to finance additional real estate ventures. The ability to extract tax-free proceeds from a real estate venture has been embedded in the tax code since its inception, and the disincentive to do so would without a doubt significantly constrict the funds available for new real estate ventures. In fact, some real estate groups have argued that such a restriction could cause a reduction in the creation of new housing stock.

3. Deductible losses. Proposed section 710 also imposes severe restrictions on the ability of the holder of an investment services partnership interest to deduct losses. Section 710(a)(2) limits the losses that can be deducted to the aggregate of the net income from the interest over net losses. Any disallowed losses can be carried forward. The provision does not appear to allow losses to be deducted to the extent of invested capital or basis in the interest. It certainly does not permit losses in excess capital accounts to be deducted in respect of investment services interests. This is a real game changer.

The ability to deduct losses is the mother's milk of the real estate entrepreneur. Under current law, losses from one real estate venture can offset income from another. The current law allows losses to be deducted in excess of capital invested in a deal. The regulations under section 704(b) allow losses to be deducted even if attributable to nonrecourse debt. This is a major shift in tax policy that will have an enormous impact on the real estate industry.

The Tax Reform Act of 1986 demonstrates what tax law can do to the real estate markets. When the passive law rules of section 469 were enacted as part of that legislation, passive investors lost their ability to use tax losses from real estate to offset other income, decreasing the flow of capital to real estate. This significantly contributed to the real estate meltdown of the late 1980s and early 1990s, which at least contributed to the savings and loan crisis of the late 1980s.

Proposed section 710 takes the loss disallowance to another level. The restrictions on the ability to claim losses from an investment services partnership interest are far more restrictive than the passive loss rules of section 469. Moreover, there is no real estate professional

[8]*See supra* note 6 for the discussion of the potential application of section 691 to the gain recognized on the postdeath disposition of an investment services partnership interest.

exemption. To the contrary, the passive investor would be treated better under section 710 than the real estate professional.

Perhaps this legislation is premised on some notion that real estate entrepreneurs make too much money and should give some back. However, that notion seems misguided in the current economic environment since the climate for investing in real estate is fragile. The economy is experiencing a major real estate downturn, and significantly curtailing the tax incentives that have historically been afforded to real estate developers could accelerate that decline.

J. The Practical Impact

If the House extenders bill or some variant of it is enacted, the shape of traditional real estate ventures will change. Under current law, there is an incentive for the real estate entrepreneur to bring in outside investors and earn a carried interest by leveraging off of other people's money. This facilitates the flow of investment capital into real estate opportunities. It also helps the real estate entrepreneur spread the risk and makes it possible for more ventures to be created. The carried interest legislation if enacted in its current form would create a disincentive for the entrepreneur to bring in outside investors. There would be a tax penalty for not self-financing projects. The entrepreneur would be more likely to do fewer deals that are self-capitalized as single-member LLCs or even corporations and, possibly, to use excessive leverage to avoid being subject to the draconian regime of section 710.

Moreover, under current law, there is a tendency to defer taxation of real estate ventures. If the tax is paid only after the venture proves successful, there is more capital left in the deal since the taxes are deferred. The carried interest law would eliminate much of this deferral. First, the entrepreneur will not be able to use any of the tax shelter available under current law. Second, there will be an incentive to pay more tax earlier in the deal so that the after-tax proceeds can be invested *pari passu* with the money partners. This would enable the entrepreneur to qualify for the qualified capital interest exemption but would leave less capital to be invested after taxes are paid.

K. Planning for Existing Partnerships

The legislation does not distinguish between existing partnerships and partnerships created after enactment. However, it seems incongruous that in midstream, the holders of interest in existing partnerships would be subject to this change in character and other tax treatment. Perhaps that can be avoided.

It seems that if the assets of an existing partnership with substantial built-in appreciation and gain, and even with liabilities in excess of basis, were contributed to a new partnership, the precontribution gain in the hands of the new partnership would be treated as capital contributed to that partnership. The capital account maintenance rules under the section 704(b) regulations would require this contributed property to be booked at its full fair market value while the precontribution gain would retain its character and be taxed to the original partners to which it was attributable under section 704(c). If the interests in the new partnership satisfy the requirements under proposed section 710 for qualified capital interest, the ordinary income treatment of the accrued appreciation for the holder of the carried interests may be largely avoided. Under proposed section 710, even a service provider should be able to avoid ordinary income treatment if the provider receives a qualified capital interest. Thus, it appears that if an existing partnership with substantial appreciation were recapitalized so that the built-in appreciation became part of the capital account attributed to qualified capital interest, then the partnership property is either actual or constructively contributed to a new partnership. The character of the accrued gains as capital gains could then be retained. It is unclear whether a mere bookup of capital accounts under reg. section 1.704(b)(2)(iv)(f) and (g) would suffice to preserve this treatment, although it certainly should since it is the equivalent of an actual contribution of property to a new hypothetical partnership. However, if the assets of the existing partnership are actually contributed to a new partnership, or if the existing partnership is subject to a section 708 termination event, the favorable treatment should apply. This may be a way to grandfather an existing partnership from the effect of section 710.

L. Planning for Post-Section 710 Partnerships

Another variation of this theme is the receipt of a qualified capital interest in exchange for contributed appreciated property under section 721. Section 710(c)(2) provides that a qualified capital interest may be received in connection with the contribution of appreciated property. There does not appear to be a requirement that the appreciated property have a basis equal to its fair market value. Therefore, precontribution gain attributable to a qualified capital interest should qualify for the qualified capital interest exception as well as the earnings thereon.

In the early stages of a real estate transaction, before the partnership has been formed and the investors recruited, the entrepreneur will typically create a valuable asset by procuring the land or contract to purchase property, securing zoning approvals and other entitlements, obtaining financing, or even providing a business plan for the venture. These items may be treated as capital or property that can be contributed to the partnership in exchange for a qualified capital interest. If the proposed carried interest legislation becomes law, the economics of deal structures may be altered. Currently, this type of property may be contributed in exchange for a lesser capital interest but greater share of residual profits. The carried interest legislation would pressure the contributors to obtain a greater share of the economics in the form of receiving a greater capital interest up front. This capital interest cannot be subordinate to other investors if it is to be a qualified capital interest. It is unclear how the market will respond to this phenomenon. Mere investors typically look to obtain a priority return of their investments. This modification will create an increased tension because of the greater risk the mere investor must tolerate to afford the promoter with qualified capital interest treatment. It is possible that this will discourage several transactions.

However, this may prove to be a viable technique in a post-section 710 world. The entrepreneur may contribute the project to the venture in exchange for a qualified

capital interest. The entrepreneur may thus create something of value before admitting the money partners and receive a capital account from the outset.

This type of capital contribution was recognized in *United States v. Frazell*,[9] in which the taxpayer contributed geological maps that were created by the taxpayer's personal efforts. Nonrecognition treatment was afforded under section 721. Likewise, in *Stafford v. United States*,[10] the court held that a letter of intent given by a life insurance company to grant the taxpayer a favorable ground lease and to loan him money to build a hotel was property in the hands of the taxpayer for purposes of section 721 even though the letter was not enforceable. There is authority for treating a contract for the purchase of property, even an oral contract, as property that can be contributed under section 351 (the subchapter C analogue to section 721).[11] There is also authority in the partnership context.[12]

M. Conclusion

The carried interest legislation, if enacted, will be a real game changer for traditional real estate entrepreneurs and ventures. This legislation may permanently alter the tax treatment and the economics of such ventures. It is possible that it will create a major disruption in the real estate industry that may take years to overcome — if it can be overcome at all.

[9]335 F.2d 487 (5th Cir. 1964).
[10]727 F.2d 1043 (11th Cir. 1984).

[11]*Ungar v. Commissioner*, T.C. Memo. 1963-159, 22 TCM 766.
[12]*Dillon v. United States*, 84-2 USTC section 9921 (S.D. Tex. 1981).