Carried Interest Bill — a ‘Death Trap’ for Real Estate Partnerships

By Stephen M. Breitstone

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Introduction

In recent years, there has been much discourse about the perception that hedge fund and private equity fund managers can structure their compensation so that they are taxed at capital gains rates on income derived from managing other people’s money. This is accomplished by granting the managers a share of profits in lieu of bigger investment management fees. This technique is normally carried out through investment entities structured as partnerships and limited liability companies taxed as partnerships. Assuming the underlying profit earned by the venture constitutes capital gain, the manager is taxable at capital gains rates on its share of profits.

The difference in tax rates can be as high as 20 percent under current law. Currently, capital gains rates are generally 15 percent, while ordinary income rates are as high as 35 percent. The realization that these investment managers are able to escape paying taxes at the normal rates applicable to compensation income has stirred a backlash among the public.

However, it appears that there is already a mechanism in section 707(a)(2) to prevent compensation from being recast as a share of profits. This provision, enacted in 1984, has never been fully implemented because of a lack of regulatory guidance. As will be explained below, the proposed carried interest legislation would go considerably further than section 707(a)(2) by recasting virtually all profits earned by the managers, whether or not a substitution for fee or compensation income, as ordinary income.

Several bills have been introduced in Congress to address the perceived abuse. The most recent version is H.R. 1935, introduced on April 2, 2009, by House Ways and Means Committee member Sander M. Levin, D-Mich. This legislation, if enacted in its current form, casts an overbroad net that encompasses traditional real estate ventures that do not entail the perceived abuse. It would wreak havoc on traditional real estate ventures — especially those that have liabilities in excess of basis or negative capital accounts. This is because, to the extent of the liabilities in excess of basis, the amount realized includes debt relief or satisfaction so that the taxable gain exceeds the available cash proceeds. In these instances, the effective tax rate on the cash proceeds can be much higher than the nominal tax rate. Although these higher effective tax rates on cash proceeds result from tax symmetry when prior debt-financed losses are recaptured or prior refinancing distributions are taxed, there has always been an escape valve from these ultimate tax liabilities in the form of the basis step-up at death under section 1014. The principals in traditional real estate ventures rely heavily on this state of the law and have conducted their affairs accordingly for generations. Under current law, the basis step-up on death prevents double taxation of these interests. The heirs will be subject to an estate tax, but the inherent income tax would be expunged. However, by reclassifying gains from carried interests as ordinary compensation income, the basis step-up on death is substantially eliminated because the gain will be deemed to be “income in respect of a decedent” under section 691.

The Economics of Carried Interests

Like its predecessors, the most recent proposal in H.R. 1935 would add section 710 to subchapter K of the code. Proposed section 710 would apply to allocations of ordinary interest from carried interests as ordinary compensation income, with the result that the basis step-up at death is substantially eliminated because the gain will be deemed to be “income in respect of a decedent” under section 691.

2Under section 691A(c), there would be a basis step-up limited to the estate taxes paid on the item of income in respect of decedent.

On June 22, 2007, a tax reform bill (H.R. 2834) that included proposed new section 710 was introduced. This provision was also included in H.R. 3996, introduced on October 30, 2007. When H.R. 3996 was finally passed, it did not include section 710. However, section 710 was included at a later date, when it was reintroduced through H.R. 6275, which was passed by the House on June 26, 2008, but was not passed by the Senate.
This is not a matter of debating whether to raise maximum marginal income tax rates on the wealthy by a few percentage points. While an increase in maximum marginal rates would be greeted with mixed sentiment, it is unlikely to create major shifts in wealth or have a major impact on the incentives to pursue profit-making endeavors. However, applying the proposed carried interest legislation to traditional real estate development and investment ventures can have a more seismic effect. This proposal would impose an entirely new tax regime on long-standing arrangements and practices, creating a confiscatory effect in some cases and undoubtedly putting major segments of the real estate investment and development community into financial ruin by exposing these arrangements to double taxation and effective overall tax rates in excess of 100 percent. Indeed, as will be explained below, those most vulnerable to this legislation are the real estate ventures that are burdened by excessive leverage. In this economic environment, those are also the most beleaguered.

**Historical Taxation of Profits Interests**

The taxation of partnership profits interests (also known as carried interests) has been embedded in the tax law for generations. There are lingering questions whether the taxation of such interests requires some degree of revision. The policy debate regarding the taxation of carried interests is intertwined with the historical taxation of the compensatory grant of partnership profits interests.

The taxation of partnership profits interests has presented perplexing practical and policy issues for our tax system for many years. In general, a major difficulty has involved whether to apply the principles of section 83 to the taxation of partnership profits interests. Moreover, there is an underlying question whether it is more appropriate to apply an "open" or a "closed" transaction approach to the grant of a compensatory profits interest when the valuation of the interest granted is difficult to ascertain.

Under section 83, the receipt of vested interests property in connection with the performance of services is generally taxable as ordinary compensation income. If the interest received is either transferable or subject to a substantial risk of forfeiture, it is treated as vested and thus its value (net of any consideration paid) is taxable on receipt. This is a closed transaction approach. It is closed in the sense that once the tax has been paid on the grant of an interest, the interest is treated like invested capital of any other taxpayer.

The compensatory tax treatment of this property is cut off once the transaction is closed and it has been subject to tax. This previously taxed capital can be reinvested or left invested in the issuing entity (if the subject property

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4 An in-depth discussion of past and present law governing the taxation of partnership interests is set forth in Breitstone & Berra, Practical Drafting Considerations for Partnership Agreements and Operating Agreements in the Closely Held Context, NYU, 66th Institute on Federal Taxation, Chapter 8 (2008).

5 Id.

6 Id.
is an interest in the employer) and is, thereafter, treated like invested capital of a nonservice provider.

Contrast the treatment of compensatory grants of property that has not vested. In general, section 83 applies an open transaction approach to unvested property. Property is not treated as vested if it is both subject to a substantial risk of forfeiture and is not transferable. Under the open transaction approach, the amount of compensation to be taxed is not determined until the property vests. There is no taxation on the receipt of the unvested property interest. However, when it vests (that is, becomes transferable or no longer subject to a substantial risk of forfeiture), it will be taxable as ordinary compensation income. If the property has appreciated during the period before vesting, all of the appreciation is taxable as ordinary income. Thus, if the property is unvested, and assuming no election is made under section 83(b) to deem the interest to be vested at the time of grant, the compensatory treatment of the item is left open so that all income derived in connection with that property interest will be taxed as compensation income. The interest will not be taxed like other invested capital of nonservice providers and, thus, will not be entitled to capital gains treatment.

The detriment of the closed transaction treatment is that the value of the property is taxed earlier in time — that is, on receipt and perhaps at a time when liquidity is not readily available to pay the tax. But if the property appreciates in value after grant, the closed transaction treatment could result in lower overall income taxation of the transaction because the postgrant appreciation would be subject to taxation at capital gains rates.

Current Law Taxation of Profits Interests

Under current law, a partnership profits-only interest is not generally taxable when it is granted. As will be described below, the liquidation approach to valuation of these interests reflects a convention that permits these interests to be valued at zero regardless of whether there is a real value to the recipient. Zero value results in zero tax at the time of grant. Valuation at zero creates a uniquely favorable result to the recipient of an interest in partnership profits only.

Because the grant is income in the section 61 sense (albeit taxable at zero value), closed transaction treatment is generally afforded to the recipient of a partnership profits-only interest. Therefore, postgrant appreciation and gains related to that interest will be treated like invested capital of nonservice providers that can qualify for capital gains treatment.

In general, the treatment under section 83 applies the same for grants of interests in partnership capital and grants of corporate stock. Normally, the valuation of a partnership capital interest is capable of being measured. Likewise, the value of stock in a corporation should be ascertainable. However, there are immense difficulties in valuing a grant of an interest in partnership profits only. The policy debate has been over whether section 83 should apply to all such grants. There is the debate over whether it is practical to tax such an interest at the time of grant because of the difficulties in determining its true fair market value. To avoid this difficulty, the tax law has historically applied the liquidation approach to valuing such interests. Under a liquidation approach the value ascribed to a profits interest is the amount that would be received by the recipient in case of a liquidation of the partnership and a distribution of the assets at that time. If the recipient would receive nothing on such a liquidation, the profits interest is generally considered to have a value of zero. This method is a fiction because the option value — meaning the right to share in future profits and appreciation from the venture — clearly has a value, albeit one that is difficult to measure. The powerful combination of the application of both the liquidation approach to valuation and the closed transaction treatment under Rev. Proc. 93-27 causes grants of compensatory partnership profits only interests to have uniquely favorable tax treatment. They are not taxed at the time of grant; but subsequent income and appreciation derived from these interests is not taxed as compensation income. Future gains can fully qualify for favorable capital gains treatment.

The treatment of compensatory profits interests is an anomaly. There exists a close analogue to these interests that receives diametrically opposite tax treatment under section 83. The analogue is compensatory grants of stock options that are not publically traded. Economically, a

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8During 2005 Treasury issued proposed regulations under sections 704(b) and 83 that address the tax consequences of the grant and forfeiture of a partnership interest for services. These proposed regulations would apply section 83 to compensatory grants of partnership profits interests. In Rev. Proc. 93-27, the Service provided the general rule that "if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, the [IRS] will not treat the receipt of such an interest as a taxable event for the partner or the partnership." Rev. Proc. 93-27 defines a profits interest by asking whether the partner would receive something if the partnership liquidated immediately after the award of the profits interest. A partner has a profits interest only if nothing would be distributed to that partner in this hypothetical liquidation.

Rev. Proc. 93-27 also lists exceptions to which it does not apply. Accordingly, receipt of a profits interest will be taxable if the profits interest relates to a substantially certain and predictable stream of income from partnership assets; if within two years of receipt of the interests, the partner disposes of the profits interest; or if the profits interest is a limited partnership interest in a publicly traded partnership within the meaning of section 7704(b).

In 2005, when the proposed section 83 regulations were introduced, Treasury also issued a proposed revenue procedure that would make Rev. Proc. 93-27 and Rev. Proc. 2001-43, 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.
partnership profits interests only interest is similar to a stock option insofar as its value is in the ability of the holder to derive future appreciation from the underlying asset. Nevertheless, under current law, the recipients of compensatory profits interests are afforded closed transaction treatment while the recipients of stock options that are not publicly traded are forced into open transaction — at least until exercise.

An inherent similarity between untraded stock options and partnership profits interest is that they are both difficult to accurately value. Like a profit-only interest, nontraded stock options have an inherent value even if they are not “in the money” — meaning the strike price is greater than the value of the underlying securities that would be received on exercise. In theory, there is value in the ability to share in the appreciation of the underlying securities. The drafters of section 83 presumably decided that because this value is difficult to ascertain, and valuation at zero probably treats the service provider too favorably, the open transaction would be used as a matter of administrative convenience.

It is interesting to note that there is an election that can be made under section 83(b) to have unvested property taxed when granted. This permits service providers to pay tax on the receipt of compensatory property interests at the time of grant. Once the interest is taxed, the transaction is closed. Thereafter, the property is treated the same as any other property, whether or not earned in connection with the performance of services. However, that election is not permitted to be made for grants of untraded stock options. For grants of partnership profits interests, the election is deemed to be made, whether or not actually made by the recipient. Therefore, under current law, closed transaction treatment of partnership profits interests is assured.

It is intriguing to note how two distinct but parallel universes of tax law have experienced diametrically opposed evolutionary outcomes. A common theme is that both nontraded options and partnership profits interests have presented significant administrative difficulties for the tax law, stemming mainly from the difficulties in valuing each type of interest. Yet in the case of stock options, which were addressed directly by Congress in the enactment of section 83, the policy decision was made to favor the government by leaving the taxation of these interests open — which will normally result in greater exposure to ordinary income taxation. On the other hand, the treatment of partnership profits interests was not, at least until now, specifically addressed by Congress. The law in this area has developed in the courts and has been augmented by administrative guidance. The outcome has been a tax treatment generally much more favorable to the taxpayer. Proposed section 710, if enacted in its current form, would not only reverse this favorable tax treatment, but it would impose a regime that is even more harsh than that afforded to options under section 83. Nontraded options can, at some point, be exercised. At that point the tax is paid and prospectively the value is treated as investment capital not derived from compensation. Proposed section 710 would not, for the most part, permit the tax to be paid. It would, in effect, impose open transaction treatment forever on the grant of partnership profits interests if they fall within the statute’s grasp.

Open Transactions Under Proposed Section 710

Proposed section 710 would take the treatment of partnership profits interests to the other extreme. If enacted in its current form, it will not only deny closed transaction treatment for profits interests to which it applies at the time of grant, but it will prevent those interests from ever being taxed like vested property interests. In effect, if the service provider receives a profits interest in connection with the performance of specified types of services, it will still be subject to open transaction treatment long after the interest has vested, so as all future profits earned from that interest will be taxed at ordinary income rates — even after the services are no longer being performed. Under proposed section 710, there will not even exist the opportunity to pay tax on the real value of the interest received so that subsequent appreciation will be taxed like other previously taxed investment capital. Unlike the nonpublicly traded options under section 83, there does not appear to be an opportunity to exercise — which will allow the tax to be paid and the previously taxed investment capital to be taxed like other investors’ capital.

As will be described below, this treatment is more than a mere change in the rates of taxation that apply to these interests. It constitutes a seismic shift in the manner of taxing these interests that can have a devastating (and, this author believes, unintended) effect on the recipient. Moreover, it will not apply only to newly created arrangements. It will also apply to long-standing arrangements that were structured in good-faith reliance on established principles of tax law.

Regarding existing long-standing partnership arrangements, proposed section 710 would cause grants of partnership profits that have long since been considered closed transactions to be reopened and to be reclassified from previously taxed capital into compensation. The notion of reopening a closed transaction seems highly questionable from a policy perspective and will have disastrous tax consequences for many taxpayers.

Section 710 and Real Estate Partnerships

The following represents an example of how the carried interest legislation would affect traditional real estate ventures:

AB real estate limited partnership was created in 1982. A, a real estate developer, contributed $20x to the partnership as its general partner and B, an investor, contributed $80x in exchange for a limited partnership interest. AB purchased a parcel of land for $100x for development. AB borrowed $400x...
from Bank to finance the construction of an apartment building. Only A was personally liable on the construction loan. A assumed sole responsibility for the partnership’s construction and management for which he was paid fees comparable to what an unrelated third party would have been paid. These fees were, of course, taxed at ordinary income rates. The AB partnership agreement provided that all profits and cash distributions would be paid to the partners in proportion to their capital contributions until they were returned along with a 10 percent return. Thereafter, profits and cash flow would be shared 50/50.

During 1983 permanent financing was obtained on the completed project in the amount of $510x. Thus, $110x was distributed in repayment of the partner’s initial capital contributions and preferred returns. A received a distribution of $22x and B received a distribution of $88x.

Fast-forward to 2009 and assume the property was on leased land and fully depreciated. Also assume that over the years, an additional $500x has been borrowed to fund improvements to the property that have also been fully depreciated. Assume the mortgage provides for payment of interest only.

The 2009 tax balance sheet of Partnership AB would be as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>$0x</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liabilities</td>
<td>($1,000x)</td>
</tr>
</tbody>
</table>

Capital accounts

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>($500)</td>
</tr>
<tr>
<td>B</td>
<td>($500)</td>
</tr>
</tbody>
</table>

Assume also that the fair market value of the project during 2009 is $1,500x. If the property were sold for its fair market value in 2009, the federal income taxation would be as follows:

- Amount realized: $1,500x
- Less adjusted tax basis: (0)
- Taxable gain: $1,500x
- A’s portion of gain: $750x
- Tax on A’s portion of gain at 35 percent = $262.5x
- Tax on B’s portion of gain = $162.5x (same as above)
- Tax as a percentage of A’s cash proceeds = 105 percent
- A’s net cash proceeds after tax and repayment of mortgage = ($12.5x)
- B’s net cash proceeds after tax and repayment of mortgage = $87.5x

This simple example illustrates the effect of changing the taxation of A’s gain from capital gains (or recapture of previous depreciation deductions) to ordinary compensation income. In a real example, the result could be even worse because there would likely be state and local taxes and employment taxes added to the tax bill.

The argument could be advanced that this result is not totally unfair insofar as A must have received some tax benefit from the depreciation of the construction and improvements over the years. Because those items were funded with the proceeds of borrowings, A would have received deductions or losses in excess of his actual economic loss and he is merely recapturing those items at the time of sale. However, when those tax benefits were available to A (assuming he could have used them), he assumed, based on the laws in effect, that eventually the inherent gain would be expunged if he held the interest or a successor interest (resulting from one or more section 1031 exchanges) in the property until death. At that point, his estate would receive a basis step-up under section 1014.

Proposed section 710 would eliminate A’s basis step-up on death. A’s built-in gain would be treated as an item of income in respect of a decedent under section 691. The effect of A being denied the basis step-up on death is that his estate or heirs would eventually be saddled with paying ordinary income taxes on his gains in addition to any estate taxes. This could result in the heirs having to pay tax on recapture of losses they did not claim. They could be taxed on refinancing proceeds they did not receive.

In the example above, because A’s pretax equity in the property was worth approximately $250x, assuming estate taxes are imposed at a rate of 50 percent, that would be an additional tax liability of as much as $125x on A’s heirs. Under section 691, there would be an income tax deduction for the estate tax. Assuming that deduction reduces the tax on the disposition of A’s interest (at a 35 percent rate) by $43.75x, A’s heirs would inherit an asset poses we will assume to be 35 percent. The calculations of federal tax liabilities would thus be:

- Amount realized: $1,500x
- Less adjusted tax basis: (0)
- Taxable gain: $1,500x
- A’s portion of taxable gain $750x
- Tax on A’s portion of gain at 35 percent = $262.5x
- Tax on B’s portion of gain = $162.5x (same as above)
- Tax as a percentage of A’s cash proceeds = 105 percent
- A’s net cash proceeds after tax and repayment of mortgage = ($12.5x)
- B’s net cash proceeds after tax and repayment of mortgage = $87.5x

*This assumes a state and local tax rate of zero.

If proposed section 710 were enacted, it would apply to A’s interest. Therefore, his share of the gain would be taxable at ordinary income rates, which for these pur-

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12This is somewhat mitigated as a result of the deduction under section 691(c) based on the estate tax paid on the item of income in respect of decedent.
worth $250x, and a tax liability of $343.75x that would have to be paid sooner or later. That is, simply put, more than confiscatory — and worse than the worst treatment proposed for the viliified executives of AIG who received bonuses.\footnote{H.R. 1586 proposed to tax bonuses received by employees of recipients of Troubled Assets Relief Program money at 90 percent for federal tax purposes. The original version of the legislation would have imposed a 100 percent federal income tax. When employment taxes such as FICA and state and local taxes are included, this would have resulted in tax rates in excess of 100 percent.}

When you combine this treatment of traditional real estate ventures with the fact that they typically do not involve the types of abuses that have been the impetus for the carried interest legislation, it seems that this legislation needs to be seriously reexamined as to its breadth and scope before enactment.

The Anatomy of Proposed Section 710\footnote{For a detailed comparison of H.R. 1935 and prior carried interest proposals, see Monte A. Jackel and Robert J. Crnkovich, "Partnership Deferred Compensation and Carried Interests," Tax Notes, Apr. 20, 2009, p. 351, Doc 2009-8166, or 2009 TNT 74-9.}

If a partnership interest constitutes an "investment services partnership interest" within the meaning of proposed section 710(c), all profits from that interest will forever 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 regarding acquiring specified assets; or
  - any activity in support of any service described in the above subparagraphs.

Section 710(c) goes on to define 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.

There is no exclusion or carveout for traditional real estate ventures. Likewise, arrangements in which no disguised compensation is present are not excluded. In the context of the typical targeted investment fund, the premise is that service providers are being paid a percentage of profits in lieu of traditional compensation or fee income. In the traditional real estate venture, typically the dealmaker who receives the carried interest also receives management fees — often greater than what a third-party manager would charge. The services element is typically compensated for by the payment of fee income. The carried interest may be principally received in exchange for taking additional risks over and above what the mere investor would incur.

Moreover, the real estate dealmaker or entrepreneur often contributes capital, either directly or through an affiliate, to the venture as well. This contribution may be in the form of cash, appreciated property, or rights and other property. Under proposed section 710(c)(2), the entrepreneur may be afforded normal capital gains treatment only if and to the extent that the interest received constitutes a qualified capital interest in which all items of income, gain, loss, and deduction allocated to that interest are identical to the treatment of those items for interests held by other unrelated partners who do not provide any services, and the allocations to the other partners are significant compared with the allocations to the qualified capital interest. Although not entirely clear, the legislation seems to permit capital gains treatment for the service provider if and to the extent of allocations of gain that are identical to those received by nonservice providers regarding contributed capital. It would appear that if the service provider contributes appreciated property that would require tax allocations under section 704(c), those allocations will be disregarded in determining whether the service provider qualifies for the qualified capital interest exception. However, this point should be clarified in subsequent versions of the legislation.

Likewise, it is not clear if a “book-up” to reflect the fair market value of underlying partnership assets under reg. section 1.704-1(b)(2)(iv)(f) would be taken into account in determining whether a service provider is entitled to qualified capital interest treatment. The legislation does provide that contribution of appreciated property would count as a contribution of capital for purposes of that exception. However, it is unclear whether deemed contributed capital resulting from a book-up would be counted. The treatment of the deemed contributed capital may also cause a refinancing to take the service provider outside the qualified capital contribution exception. For example, it is unclear whether a service provider with a negative capital account would continue to qualify for the qualified capital contribution exception. It would seem that this exception should continue to apply if and to the extent that the service provider is treated no differently from any other partner.

Perhaps the impact of these provisions would be minimized if the only interest received in the venture is a qualified capital interest. Thus, if the service provider received a fee upfront in the venture reflecting the value of the initial services performed, paid tax on that amount, and then invested the post-tax proceeds in the venture in exchange for an additional qualified capital interest, an interest could potentially avoid the reach of proposed section 710. However, in the real world, that may not be practical. Partnership structures are required to be flexible enough to reflect many economic factors that would not be permitted to be reflected under proposed section 710 without invoking severe adverse tax consequences. As already discussed, investors may insist on a preferential return of their invested capital because of their negotiating leverage and lesser ability to assess the risks of the deal. Even if the service provider receives the same ultimate profits participation, mere subordination of the order of returns of capital can cause the service provider to fall outside the qualified capital interest exception.
Likewise, additional profits interests received for guaranteeing debts of the partnership or investing at an earlier stage will fall outside that exception.

Proposed section 710 would significantly distort economic behavior by making sensible deal structures unpalatable. If, for example, the entrepreneur agrees to allow the investors to receive a priority return of their capital, the open transaction approach is foisted on the entrepreneur, creating ordinary income forever. Likewise, if the entrepreneur agrees, in exchange for subordinating his capital, to receive a greater share of the back end profits — a carried interest — he will be subject to ordinary income treatment forever under section 710. This is true even though neither of these scenarios involve the performance of services. Lastly, if the entrepreneur decides not to admit investors to the partnership and instead to put up all the equity capital himself — or to borrow it — he can entirely avoid the reach of section 710. The adverse tax regime imposed on entrepreneurs who take in investors can thus be avoided by taking on greater risk — using borrowed capital and not spreading the risk by including investors. This would be a highly dubious influence on business activity that results in the creation of capital in this economy.

Perhaps the open transaction treatment afforded under proposed section 710 constitutes a backlash from the current favorable treatment of partnership profits interests. As discussed above, partnership profits interests are afforded closed transaction treatment even though the grant of a mere profits-only interest is generally not a taxable event. Perhaps a better approach than imposing open transaction treatment forever is to give the taxpayer the option to be taxed upfront on the grant of the interest at its value at the time (real economic value rather than the historical method of valuing profits interests on the basis of a hypothetical liquidation approach). But there are practical difficulties with this approach. It is difficult to value the compensatory element of these transactions. Carried interests are not granted solely for services. They often result from a negotiated allocation of risks and rewards — inherent in all business deals — and are normally facilitated by the flexible nature of partnerships through which income and loss can be allocated under complex but negotiated arrangements that take into account many factors.

Perhaps, in lieu of applying open transaction treatment forever, a better approach would be to ascribe a minimum value required to be taxed on the receipt of a profits interest. For example, section 2701 applies this approach in the context of a partnership freeze transaction in which profits interests are issued to accomplish estate planning objectives. A similar approach could be applied to carried interests granted for services. Perhaps the recipient should be given the election to be taxed currently as a deemed minimum value.

Conclusion

Proposed section 710 would dramatically change the landscape for the taxation of traditional real estate tax partnerships. It seems unlikely that Congress fathoms the devastating unintended consequences to long-standing traditional real estate tax partnerships. The policy justifications for applying proposed section 710 to existing traditional arrangements are dubious. Carried interests are often granted to the dealmaker in a real estate partnership for reasons that have little or nothing to do with the performance of services. These interests are typically granted to compensate the dealmaker for taking bigger risks — either by advancing capital before the investors came into the deal or later for taking a subordinated return of capital. Moreover, typically, the dealmaker in a real estate partnership either directly or through an affiliate receives fees for any services that are often equal to or greater than the fees that an unaffiliated service provider would charge.

It has been argued that the recipients of carried interests have done more than merely provide capital. It is their active role that justifies the receipt of the carried interests in whole or in part. Therefore, there is a services element to the grant. This may well be true. However, that is not a justification for applying the open transaction approach forever and for treating all profits derived in connection with the activity as compensation for services. This all-or-nothing approach unnecessarily punishes the entrepreneur for engaging in legitimate capital formation activities. Also, the exception for an interest received solely for capital is far too narrow. It would impede the healthy allocation of risks and rewards in a venture to reflect economic realities. Many deals that should happen will not work. Investors, who typically want a priority return of capital, will not understand the need to allow the entrepreneur to share in that priority return to avoid the application of the carried interest rules. Entrepreneurs will be discouraged from taking risks that the favorable capital gains rates are intended to encourage. Perhaps even worse, entrepreneurs will be encouraged to use borrowed capital rather than bring in equity investors because treating the equity investors as required will also have the effect of subjecting the entrepreneur to ordinary income treatment forever.

The scope of carried interest legislation needs to be carefully considered before its enactment. Perhaps there are situations in which it is warranted. Perhaps the grant of a carried interest in some fund arrangements is a substitute for compensation income. However, it is unwise to apply this legislation across the board to traditional real estate ventures. Moreover, there may be devastating consequences to applying this legislation to long-standing real estate ventures that involve significant leverage or debt in excess of basis. For these ventures, the carried interest legislation would result in a denial of the basis step-up at death, would cause double taxation by imposing both an estate tax and an income tax on phantom profits, and could increase the effective rate of gain on the sale of interests in these ventures to substantially more than 100 percent.