Real estate tax services

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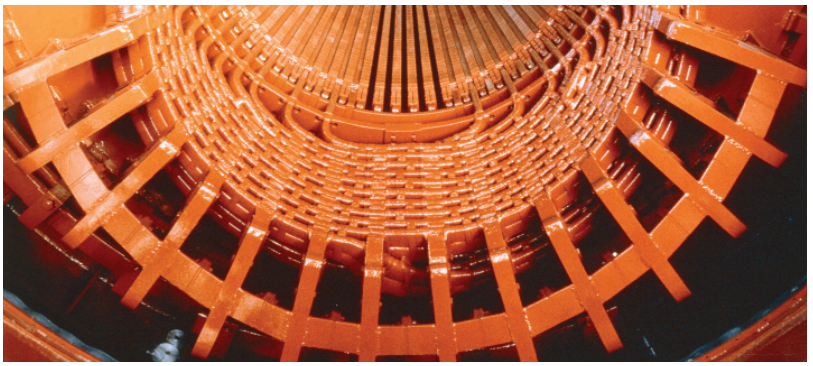

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The carried interest proposal

What it means to real estate funds

Since 2007, Congress has debated the passage of legislation to treat income from "carried interest" arrangements as the equivalent of compensation for services. Following some recent horse trading between Members of Congress involving this and other tax revenue issues, legislation may finally pass with this effective tax increase serving as one of the required revenue offsets in the American Jobs and Closing Tax Loopholes Act of 2010 (H.R. 4213). Now that the legislation is further along in the process, if you haven't done so already it's time to take a closer look at what final passage would mean for real estate funds.

What is the proposal?

While the structure of "carried interest" arrangements vary, such arrangements generally include a fund manager's right to receive a larger share of profits after investors have received a certain agreed upon rate of return (the "hurdle rate") on their investment. Generally, the hurdle rate is reached after investments have been sold and appreciation has been realized. The character of income realized by the fund in these events is typically (although not always) capital gain income. Because real estate funds are structured as partnerships for tax purposes, this income flows through to the partners, including the fund manager, as capital gain.

While there is no dispute that the partnership's transaction produces a capital gain, the "rub" is that this gain is shared among partners disproportionately to their original investment sharing ratios. This agreement, typically negotiated in the beginning of the life of the fund, incentivizes the service partner and thus may be viewed as compensation for their services. Therefore, Congressional proposals have been aimed at changing the character of the income that flows through to partners who perform services to certain partnerships (e.g., hedge funds, private equity funds, and real estate funds). Specifically, Congress would tax the income received by the service partner as ordinary income (subject to self-employment tax) regardless of the character of the income earned by the partnership and realized by the other partners. While it is true that these proposed rules would apply only to amounts in excess of the service partner's return on invested capital, that excess represents the lion's share of the return earned by the service partner if the fund is successful.

The current proposal is for the most part drafted similarly to prior proposals, with the general aim of treating all partnership income allocated to service partners in excess of their invested capital as ordinary income, but with some compromises. The compromise, however, is a matter of degree. As currently drafted, 50% of these amounts would be re-characterized from the date the proposal is enacted through 2012 (for calendar year taxpayers). Thereafter, 75% of these amounts would be subject to the new rules. It should be noted that with the recent passing of the health care reform legislation, effective in 2013 Medicare tax will be due (generally) on net investment income including capital gains. Therefore, beginning in 2013 Medicare tax will apply to the carried interest income with or without this carried interest legislation.

Is there a way to structure around the proposal?

Since the day this legislation was proposed, practitioners have been contemplating alternative structures and arrangements in order to preserve capital gain treatment. Congress has reacted in some cases by inserting "anti-abuse" provisions preventing arrangements such as borrowing funds from the limited partners so that the service partner can establish a larger invested capital interest. The current version of the proposal would also cover other types of interests (e.g., options) held in other entities (excluding fully taxable entities) which might have been used to replicate the current tax treatment for the carried interest.

Given the broad scope of the legislation, a fundamental change in the economic arrangement between the fund managers and investors may be needed if fund managers wish to retain full capital gain treatment on their share of appreciation. Alternatively, the carried interest could be replaced by an incentive fee arrangement. The fundamental economic arrangement would be undisturbed, but the fund manager would receive ordinary fee income as compensation for services. The investors in the fund, on the other hand, would receive an ordinary deduction for the fee rather than a decreased share of capital gain income, assuming that the fee would be treated as an ordinary trade or business deduction, which is generally feasible in real estate partnerships but would need to be analyzed on a case-by-case basis.

Factors to consider when structuring the economic transaction as a fee versus a profits interest include state and foreign tax credit considerations. For state tax purposes, under the current proposal the re-characterization as ordinary income may not significantly change state tax implications in multi-state jurisdictions since the income is still flowing through the partnership. Restructuring the service partner's partnership income as fee income, however, would most likely source the fee wholly to the state where the services are provided. Depending on where this state is as compared to the states of the underlying property in the partnership could result in a better state tax answer. At a minimum, the silver lining of a fee arrangement could be the reduced compliance costs for service partners currently filing in multiple jurisdictions for funds with real estate activities in multiple states.

For foreign tax credit purposes, US versus foreign sourcing rules should also be considered. It is unclear in the current proposal if a service partner's receipt of carried interest in a tax-transparent foreign real estate fund should still be considered foreign source income for foreign tax credit purposes. A fee arrangement, on the other hand, could be treated as US-sourced income depending on where the services are performed, which could have an impact on the computation of the individual's foreign tax credits.

Overall, absent changing the economic arrangement between fund managers and investors, structuring to achieve an allocation of capital gain income to fund managers in the real estate fund industry is unlikely if the current proposals are enacted. However, we strongly encourage a broader tax analysis be undertaken to consider state tax implications, foreign tax credit computations, and the complexities of partnership tax compliance.

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Massachusetts legislative changes

Impact on REIT clients

Massachusetts tax changes may have significant implications for our real estate clients, particularly REITs, with activities in Massachusetts. Specifically, effective for tax years beginning on or after January 1, 2009, the legislation conforms Massachusetts to the federal entity classification rules and adopts mandatory combined reporting.

Impact of federal conformity on corporate excise net worth measure of REIT structures

Former Massachusetts tax law

- For tax years beginning prior to 2009, Massachusetts treated qualified real estate investment trusts' subsidiaries ("QRSs") as regarded entities for purposes of the corporate excise's net worth measure. Thus, a REIT that did not have a connection to Massachusetts other than owning Massachusetts property through a QRS generally did not have a net worth liability (rather this liability was typically paid by the QRS).
- In computing the net worth excise due under prior law, a QRS with Massachusetts presence would receive a deduction against the entity's net worth base for its Massachusetts property subject to local taxation. Therefore, under the former tax regime, a QRS that only owned Massachusetts real estate would have had a taxable net worth of zero, as its only asset would have been deductible Massachusetts property.

Current Massachusetts tax law

- For tax years beginning on or after January 1, 2009, QRSs will be disregarded for Massachusetts corporate excise purposes.
- As a result of this new legislation, the net worth tax is computed at the parent REIT level rather than at the QRS level. Thus, the Massachusetts tax liability of a REIT cannot be isolated and managed within a QRS.
- Under the new law, the apportioned net worth of the REIT will be based upon the attributes of the REIT, its QRSs and its lower tier flow-through entities or disregarded entities.
- To the extent that our clients had a QRS with a substantial Massachusetts presence (relative to the Massachusetts presence of the parent REIT or its QRSs in the structure), such taxpayers may find that this law change results in significant increases to their overall Massachusetts net worth tax liability.
- Note that REITs that are registered with the SEC are subject to a different calculation to determine their taxable net worth, which typically yields better results than the general formula that most private REITs are required to use.

Mandatory combined reporting relative to the corporate excise net income measure

- Prior to 2009, Massachusetts was traditionally a separate reporting state.
- After 2009, a corporation that is engaged in a unitary business with one or more commonly owned corporations will be required to file on a combined basis with its unitary affiliates.
  - However, each member of the combined group with a taxable presence in Massachusetts will continue to compute the non-income measure of the corporate excise on a separate basis. As stated above, however, Massachusetts will conform to the federal disregarded treatment of QRSs and therefore the attributes of QRSs will be imputed to their parent REIT for purposes of the net worth measure of the tax.
- All types of entities are now eligible for inclusion in a combined report of a unitary group, including general business corporations, S Corporations, certain financial institutions, insurance companies (only if not classified as such for federal income tax purposes), REITs, TRSs, RICs and utility corporations.
- A REIT therefore must be included in a combined report with other corporate affiliates that are commonly owned more than fifty percent and share a unitary relationship. However, a REIT subject to a combined filing may nevertheless claim a deduction for dividends paid.
- For REITs that have dealt with the complexity of unitary combined filing in other states, the calculation of the net income measure under the Massachusetts combined reporting regime may produce unexpected results.

Next steps

Due to these significant changes in Massachusetts laws, our clients should review their structures to determine their combined group for purposes of their 2009 corporate excise filings as well as the impact of the recent changes on their net worth tax.

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