

Vinson&Elkins

REIT Series

Impact of Final Carried
Interest Regulations on REITs
and Real Estate Funds

Speakers:

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Speaker Bios



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Chris is a nationally-recognized authority on real estate investment trust (REIT) taxation, real estate funds, and real estate partnerships. He works with REITs, real estate companies, and private equity sponsors on IPOs, mergers and acquisitions, real estate fund formation, qualified opportunity zone funds, joint ventures, take-private transactions, spin-offs, financings, dispositions, recapitalizations, and issues relating to foreign investment in U.S. real estate under FIRPTA. Chris works with his clients to provide practical and commercial solutions to tax issues oriented toward achieving their business goals. His work has earned him recognition in *Chambers USA*, where reviewers praised Chris as “a very impressive lawyer” with a “strong understanding of REIT tax consequences.” He is also recognized by *Legal 500* (US) in US Real Estate-REITs.



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Paige’s practice focuses on the federal income tax aspects of business transactions, particularly in the real estate industry. She advises real estate investment trusts (REITs), private equity sponsors, and other investors on a variety of tax matters, including tax planning associated with equity and mortgage REITs, qualified opportunity zones, capital markets transactions and IPOs, mergers and acquisitions, joint ventures, reorganizations, and financings.

General Overview

What Is It?

- A “carried interest” is a share of any profits of a partnership – typically a private equity venture or a hedge fund – that is received in exchange for services to or for the benefit of the partnership, independent of any capital contribution.
- Often referred to as “promote” or “promoted interest” in the real estate context.
- For tax purposes, a carried interest is a “profits interest” in a partnership.
- A “profits interest” is defined as any interest in the partnership that is not a “capital interest,” which is in turn defined as “an interest that would give the holder a share of the proceeds if the partnership’s assets were sold at fair market value and then the proceeds were distributed in complete liquidation of the partnership.”

Pre-TCJA Tax Treatment

- Under safe harbors in the Revenue Procedures 93-27 and 2001-43, the IRS will not treat the receipt or vesting of a profits interest in a partnership in exchange for services to or for the benefit of the partnership as a taxable event to the recipient or partnership. Therefore, a holder of a carried interest is not taxed upon receipt of the interest or vesting, if applicable.
- As a partner, the holder of the carried interest receives a distributive share of partnership income and gain. This income and gain retains its character, including, to the extent applicable, as long-term capital gain (“LTCG”) taxed at preferential rates.
- Prior to the Tax Cuts and Jobs Act of 2017, LTCG was treated as such pursuant to the typical 1 year holding period requirement.

What Does It Do?

- At a high level, Section 1061 operates by providing that preferential LTCG rates are not available to a holder of a carried interest unless a 3-year holding period requirement for the underlying asset or interest is met (as opposed to the typical 1-year holding period requirement for LTCG) or an exception applies. The holding period of the direct owner of the asset or interest controls. As a result, if the partnership disposes of an asset that it has held for more than 3 years, a holder of an API can still get LTCG treatment even if it has held the API for less than 3 years.
- Gain that is not eligible for LTCG treatment under this rule is treated as short-term capital gain (“STCG”).
- The amount treated as STCG is known as the “Recharacterization Amount.” If a taxpayer holds multiple interests subject to Section 1061, capital gains and losses that would otherwise be LTCG and LTCL are aggregated for purposes of determining the Recharacterization Amount.
- STCG is generally taxed at ordinary rates (currently 37%).

Applicable Partnership Interests

- Section 1061 does not use the term “carried interest” or “profits interest,” but instead applies to “applicable partnership interests” (“APIs”).
- An API is an interest in a partnership that is directly or indirectly transferred or held by a taxpayer in connection with the performance of substantial services by the taxpayer, or a related person, in an “applicable trade or business” (“ATB”).
- Once an interest is classified as an API, it generally retains its status as such, regardless of a change of ownership or circumstances, unless and until an exception applies.

Applicable Trade or Business

- An ATB is “any activity conducted on a regular, continuous, and substantial basis” through one or more entities that consists, at least in part, of:
 - Raising or returning capital; and
 - Investing in, disposing of, identifying for investment or disposition, or developing “specified assets.”
- The IRS rejected a comment requesting a bright line rule that a joint venture of a real estate developer involving a single stand-alone project at a single location will not constitute an ATB, stating that the determination of whether such a project involves a sufficient level of activity to constitute a trade or business is a facts and circumstances determination that must be made under Code § 162.

Specified Assets

- “Specified assets” include securities (including all corporate stock and interests in widely held partnerships), commodities, real estate held for rental or investment, cash or cash equivalents, and any interest in a partnership to the extent that such partnership holds specified assets, and any option or derivative with respect to the foregoing.
- Specified assets do not include interests in a closely held operating partnership except to the extent the operating partnership holds specified assets.

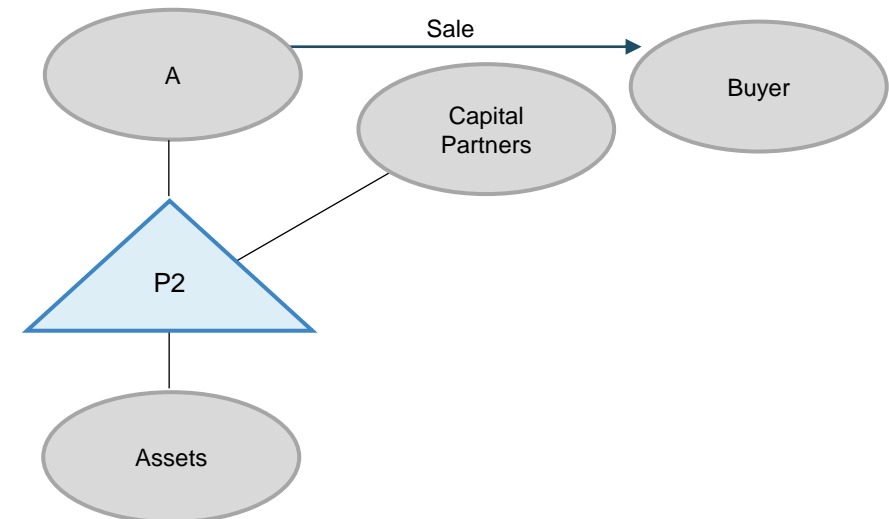
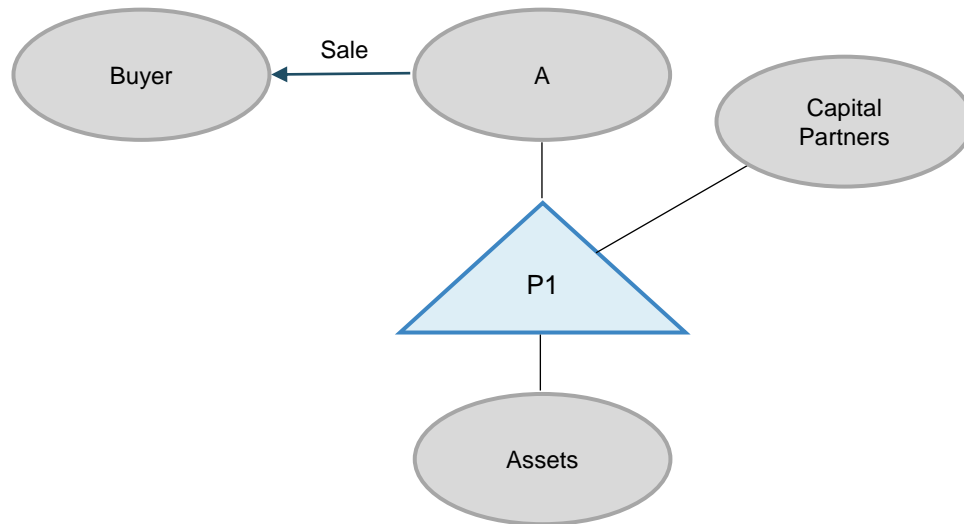
Recharacterization Amount

- The Recharacterization Amount is calculated as:
 - the sum of the taxpayer's (A) combined net distributive shares of net LTCG or LTCL with respect to all APIs held by the taxpayer, calculated without the application of Section 1061 (the "API One Year Distributive Share Amount"), and (B) the combined net amount of LTCG and LTCL recognized by the taxpayer during the taxable year from the disposition of APIs (including as a result of the application of Section 731(a) to a distribution) (the "API One Year Disposition Amount", and the sum, the "One Year Gain Amount") less
 - the sum of the taxpayer's (A) API One Year Distributive Share Amount, less items included in the API One Year Distributive Share Amount that would not be treated as a LTCG or LTCL if three years is substituted for one year in paragraphs (3) and (4) of Code § 1222 and (B) the combined net amount of LTCG and LTCL recognized by the taxpayer during the taxable year from the disposition of APIs held for more than 3 years (including as a result of the application of Section 731(a) to a distribution), "Three Year Gain Amount".

How Section 1061 Applies Generally

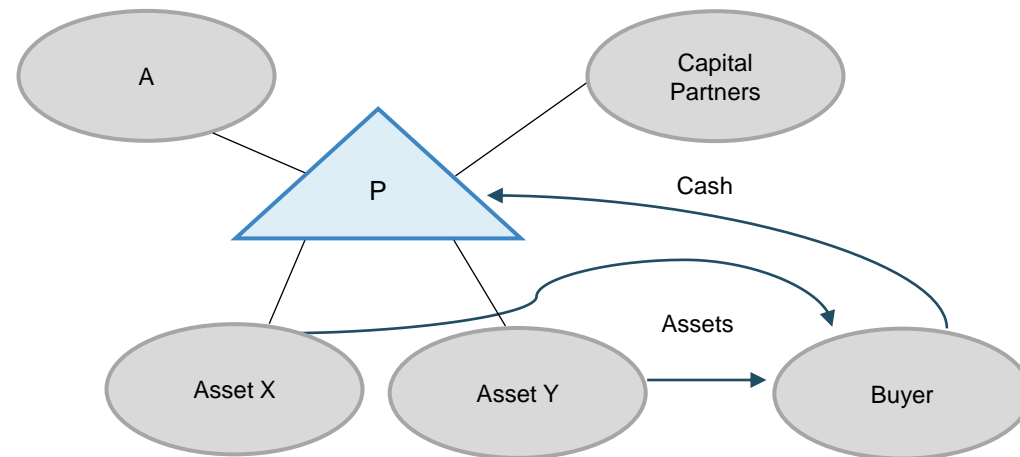
Sale of API

- Assume *A* holds APIs in partnerships *P1* and *P2*, but no capital interests.
- After holding the API in *P1* for 4 years, *A* sells the API at \$100 gain.
- *A* also sells the API in *P2*, which *P* has held for 2 years, at \$50 gain.
- In this example, *A*'s One Year Gain Amount is \$150, and *A*'s Three Year Gain Amount is \$100.
- As a result, *A*'s Recharacterization Amount is \$50, and *A* has \$50 of STCG and \$100 of LTCG.



Sale of Underlying Asset

- Assume *A* holds an API in partnership *P*, but no capital interest.
- During the taxable year, *P* sells asset *X*, which it has held for 2 years, and asset *Y*, which it has held for 5 years.
- *P* allocates to *A* \$20 of gain with respect to asset *X* and \$40 of gain with respect to asset *Y*.
- In this example, *A*'s One Year Gain Amount is \$60, *A*'s Three Year Gain Amount is \$40.
- As a result, *A*'s Recharacterization Amount is \$20, and *A* has \$20 of STCG and \$40 of LTCG.



Lookthrough Rule

- Under the “Lookthrough Rule,” a portion of gain on the disposition of an API held for three years or more may still be recharacterization as STCG based on the partnership’s holding period of its underlying assets.
- The Lookthrough Rule applies if the holder’s holding period in its API would be three years or less if determined without including any portion of the holding period before the date that an unrelated investor was legally obligated to make a capital contribution that is at least 5% of the value of the partnership’s assets, valued at the time of the API disposition.
- This rule is intended to discourage funds from establishing partnerships and leaving them inactive for three years before bringing in outside investors, but may be triggered in other instances such as tiered arrangements (employee co-invest vehicles and other upper-tier partnerships) in which is little or no outside capital in the partnership that issued the API.

Transfers to Related Parties

- Section 1061(d) operates to recharacterize any LTCG that would otherwise be recognized on a transfer of an API to a “Section 1061(d) Related Party” to STCG to the extent of the transferred API’s share of the partnership’s unrealized LTCG in its assets with a holding period of three years or less.
- A Section 1061(d) Related Party only includes (A) a member of the API holder’s family within the meaning of Code § 318(a), (B) a person that performed a service in a relevant ATB to the API in the current or 3 previous calendar years, or (C) a pass-through entity in which a person described in (A) or (B) owns an interest, directly or indirectly.
- In the Proposed Regulations, the IRS had adopted an expansive interpretation of Section 1061(d) that would have required recognition in connection with transfers that would otherwise qualify for nonrecognition (e.g., gifts), but reversed on this position in the Final Regulations.

Exceptions

- Capital Interest: An API does not include a capital interest which provided the right to share in partnership capital commensurate with (A) the amount of capital contributed or (B) the value of such interest subject to tax under Code § 83 upon receipt or vesting.
- Employee of a Different Partnership: An interest is not an API if it was issued to a person in connection with the performance of substantial services by the person as the employee of another entity that is conducting a non-ATB trade or business and such person only provides services to that entity.
- Corporation: An API does not include any interest held, directly or indirectly, by a corporation, which, for this purpose, does not include an S-corporation or a passive foreign investment company for which a qualifying electing fund election is in effect.
- Third-Party Purchaser: An API will cease to be an API upon purchase by a third-party purchaser only if the purchaser is a bona fide purchaser who (A) does not provide services to the relevant ATB, (B) is unrelated to any such service provider, and (C) acquired the API for fair market value.

Capital Interest Exception

- “Commensurate” Requirement: A capital interest will be considered commensurate with the amount of capital contributed if allocations made to the API holder with respect to such interest are determined and calculated in a manner similar to the allocations with respect to capital interests held by similarly situated partners who have not provided services to the relevant ATB and who are not, and have never been, related to any API holder in the partnership or any person who provides, or has provided, services in the relevant ATB (“Unrelated Non-Service Partners”) who have an aggregate capital account balance of 5% or more of the total capital accounts of the partnership (the “Similar Manner Test”).
- The Similar Manner Test may be applied on an investment-by-investment or class-by-class basis. Factors to be considered include: amount and timing of capital contributed, the rate of return on capital contributed, the terms, priority, the type and level of risk, and the rights to cash and property distributions.
- A capital interest may be subordinated to allocations made to Unrelated Non-Service Partners and does not have to be reduced by the cost of services (i.e., management fees and carry). It also may receive tax distributions to which Unrelated Non-Service Partners are not entitled.
- Capital interest allocations must be clearly identified under both the partnership agreement and on the partnership’s books and records as separate and apart from the holder’s API allocations.

Sale of Combined API and Capital Interest

- The Final Regulations provide that all LTCG or LTCL on the sale or disposition of an interest is deemed to be attributable to the API unless it is determined under Treas. Reg. § 1.1061-3(c)(4)(ii) that a portion of the gain or loss is attributable to the capital interest.
- Process:
 - First, determine the amount of LTCG or LTCL that would be allocated to the interest sold if all the assets of the partnership (including any assets of any lower-tier pass-through entities) were sold for their fair market values in a fully taxable transaction immediately before the disposition of the interest.
 - Second, determine the amount from such hypothetical sale that would be allocated to the interest as a capital interest allocation.

Sale of Combined API and Capital Interest (Cont'd)

- LTCG on Disposition/STCL or LTCL on hypothetical sale of asset
 - All LTCG on disposition treated as attributable to API
- LTCG on Disposition/No STCL or LTCL on hypothetical sale of asset
 - LTCG attributable to capital interest: $\text{Total LTCG} \times \left(\frac{\text{LTCG on hypothetical sale allocated to capital interest}}{\text{Total hypothetical LTCG}} \right)$
- LTCL on Disposition/STCG or LTCG on hypothetical sale of assets
 - All LTCL treated on disposition as attributable to API
- LTCL on Disposition/No STCG or LTCG on hypothetical sale of assets
 - LTCL attributable to capital interest: $\text{Total LTCL} \times \left(\frac{\text{LTCL on hypothetical sale allocated to capital interest}}{\text{Total hypothetical LTCL}} \right)$

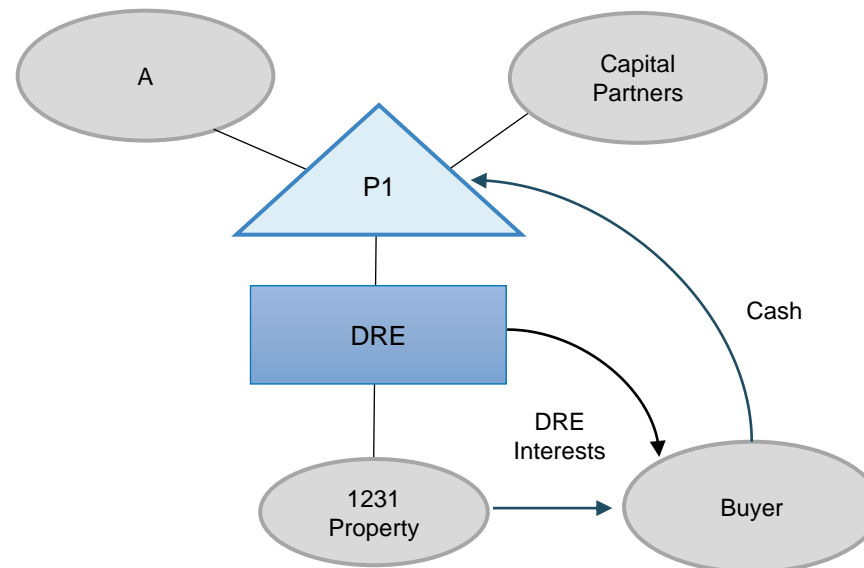
Application to Real Estate

Generally

- By its terms, Section 1061(a) extends the holding period for LTCG to 3 years by substituting “3 years” for “1 year” in Sections 1222(3) and 1222(4).
- Section 1231, which applies to gains and losses realized on the sale or conversion of property (including real property) used in a trade or business, provides that if Section 1231 gains exceed Section 1231 losses, the net amount is treated as LTCG, without reference to Section 1222.
- The Final Regulations confirm that Section 1231 gains are not subject to Section 1061(a).
- This means that, in the context of real estate, the result under Section 1061(a) may vary depending on whether the LTCG of the partnership is attributable to an asset sale of real property or equity interests in a recognized entity holding such real property.
- However, there is some question as to whether gains and losses from the sale of triple-net leased property qualify as Section 1231 gains and losses.

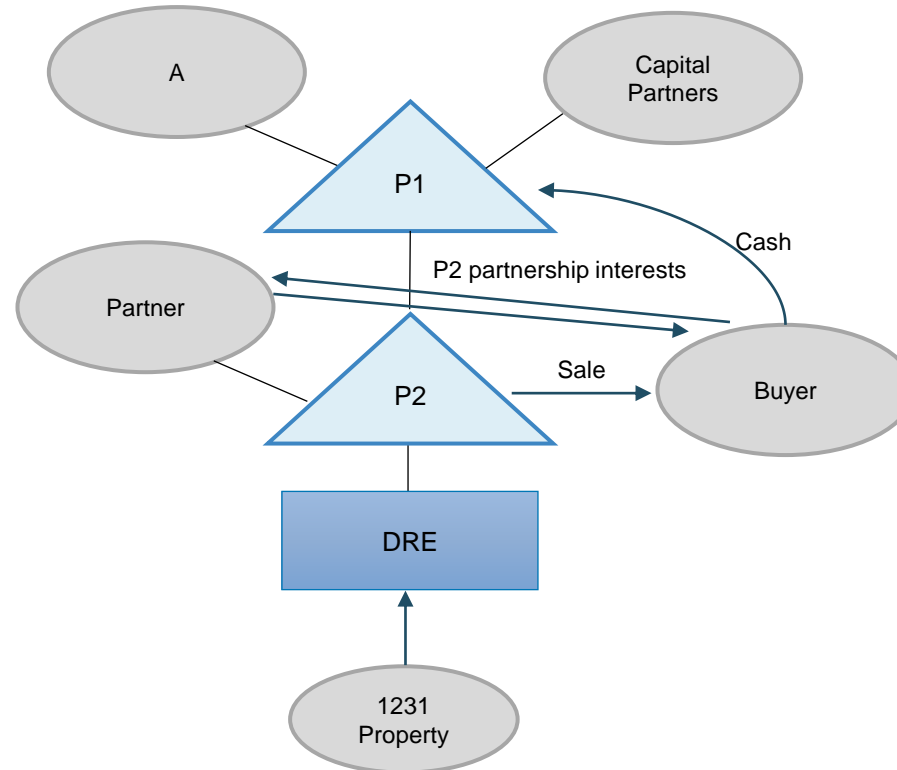
Generally – Sale of Real Property vs. Sale of Partnership Interest

- Example 1: A holds an API in *P1*. *P1* has held real estate asset *X*, which is Section 1231 property, through *DRE*, a disregarded entity, for 2 years. *P1* sells the interests in *DRE*, which is treated as an asset sale for tax purposes, at a gain. Because *X* is Section 1231 property, A's allocable share of the gain from the sale of *DRE* is not subject to Section 1061(a).



Generally – Sale of Real Property vs. Sale of Partnership Interest

- Example 2: Same as Example 1, but instead of holding *X* through *DRE*, *P1* holds *X* through *P2*, which is a partnership for tax purposes. *P1* sells its interests in *P2* at a gain. The gain is subject to Section 1061(a) and *A*'s allocable share is recharacterized as STCG.



Short-Term Capital Gain vs. Ordinary Income

- Taxed at same rate (currently, maximum of 37%).
- STCG not subject to the self-employment tax.
- STCG may not be subject to 3.8% tax for qualified real estate professionals.

Capital Gain Dividends

- Unless specified by the REIT on Form 1099-DIV, REIT capital gains dividends are presumed to be attributable to the gain from the sale of capital assets held for more than 1 year, but less than 3 years (and not Section 1231 gains) and therefore subject to Section 1061(a).
- A REIT may choose to disclose on Form 1099-DIV the amount of capital gain dividends that are attributable to Section 1231 gains or attributable to capital assets held for more than 3 years.

LTIP Units

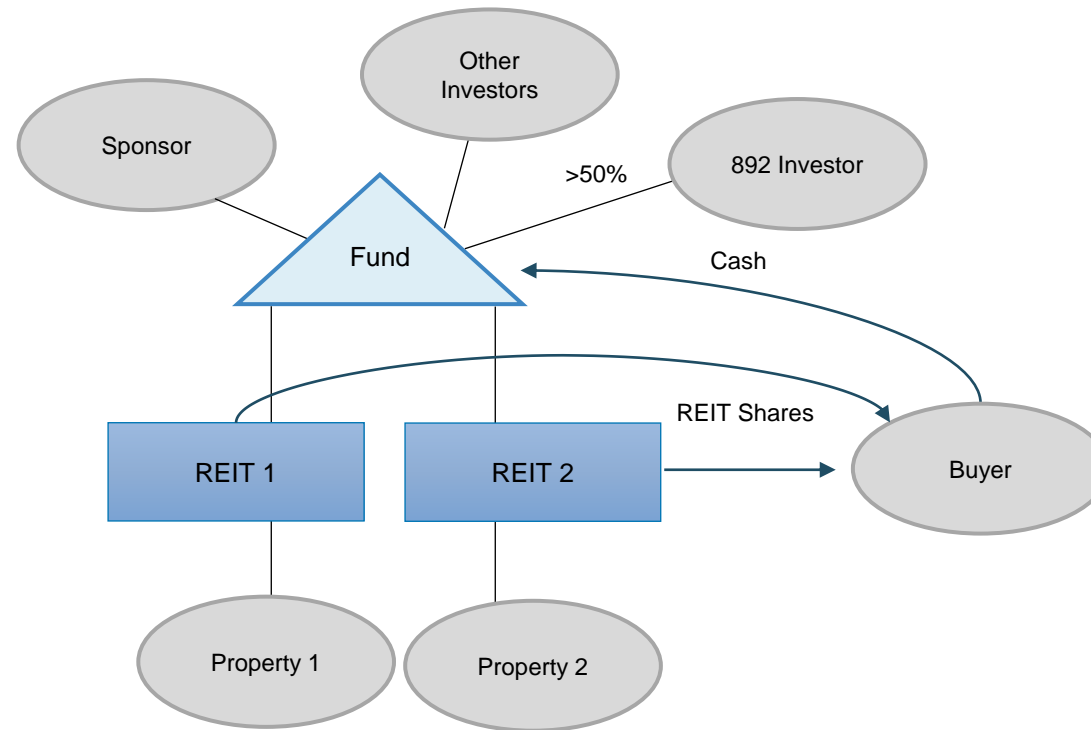
- Long-term incentive plan units (“LTIPs”) are a special class of profits interests in a REIT’s operating partnership that are entitled to distributions equivalent to those on the common units/REIT stock and are eventually convertible into common units (and ultimately redeemable for cash or REIT stock, at the REIT’s option).
- Conversion to Common Units: The conversion is not taxable, but the interest remains an API even though it is no longer an LTIP.
- Section 1061(a) Consequences on Redemption:
 - If held for 3 years or less, an LTIP unit is subject to Section 1061(a) when it is redeemed for cash or REIT stock.
 - If held for more than 3 years, a portion of the gain could still be recharacterized as STCG if the operating partnership owns assets with built-in gains that would be subject to Section 1061(a) (e.g., partnership interests or REIT stock held for more than one year, but less than three years).
- Holding Period Considerations: A holder can not specify which common units received for LTIPs are being redeemed. If a portion of the holder’s interests have been held for less than 3 years, a pro rata portion of the gain (based on relative FMV) may be attributed to those interests and subject to Section 1061(a). The Treasury is continuing to study this issue.

Real Estate Funds

- Fee-Free/Carry-Free Investments: The Final Regulations confirmed that a capital interest will not fail to qualify for the capital interest exception solely because it is not reduced by the “cost of services,” which includes management fees and carry allocated to the related APIs.
- Holding Period Considerations: If an API holder disposed of a portion of its APIs, it cannot not specify which APIs the disposition relates to. If a portion of the API holder’s interests have been held for less than 3 years, a pro rata portion of the gain will be attributed to those interests and subject to Section 1061(a).

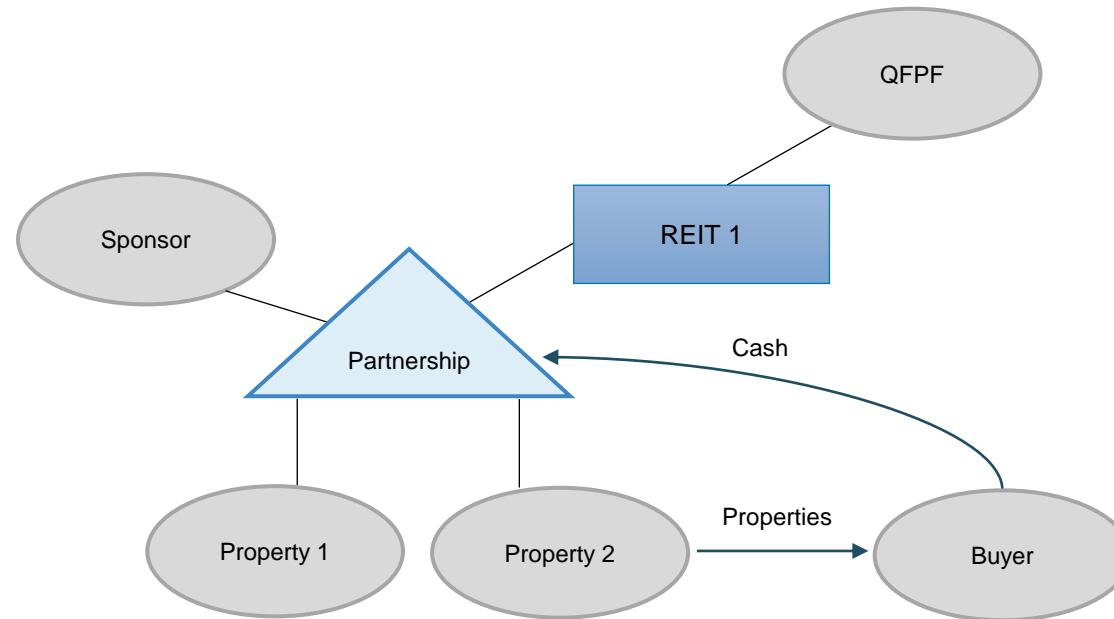
Real Estate Funds (Cont'd)

- Section 892 Investors will want to hold assets through private REITs and exit investments through a share of REIT sales, which, if held for less than 3 years, will produce Section 1061(a). Management, instead, will prefer a sale of the assets if such would produce Section 1231 gain not subject to Section 1061(a).



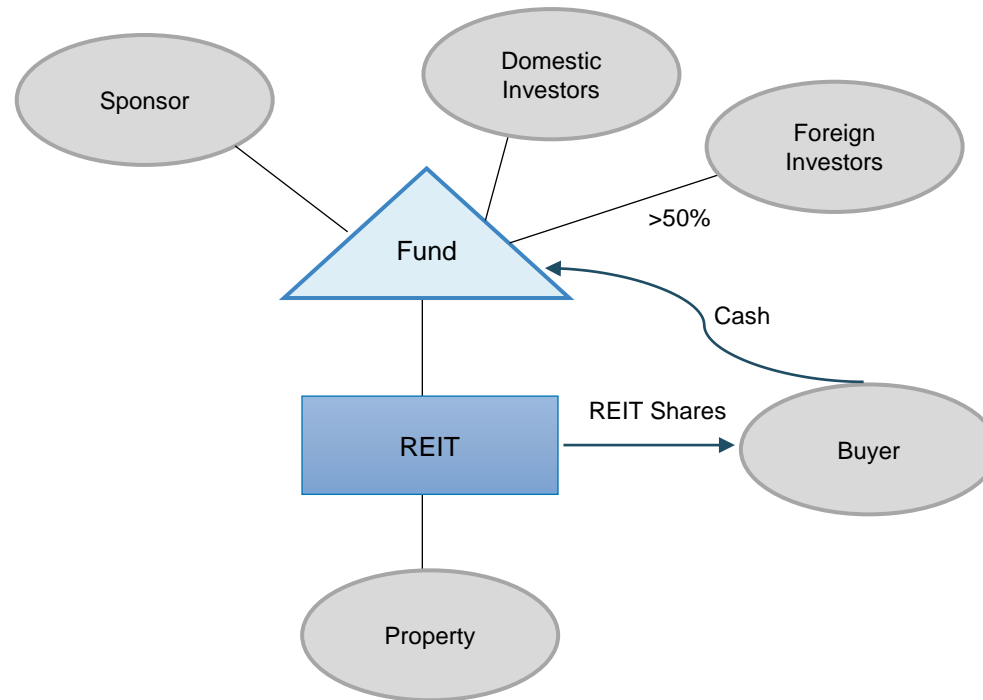
Real Estate Funds (Cont'd)

- QFPFs may be willing to sell assets, but may want to exit after 2 years, which will still be within the recharacterization period to the extent that the asset is not a Section 1231 asset.



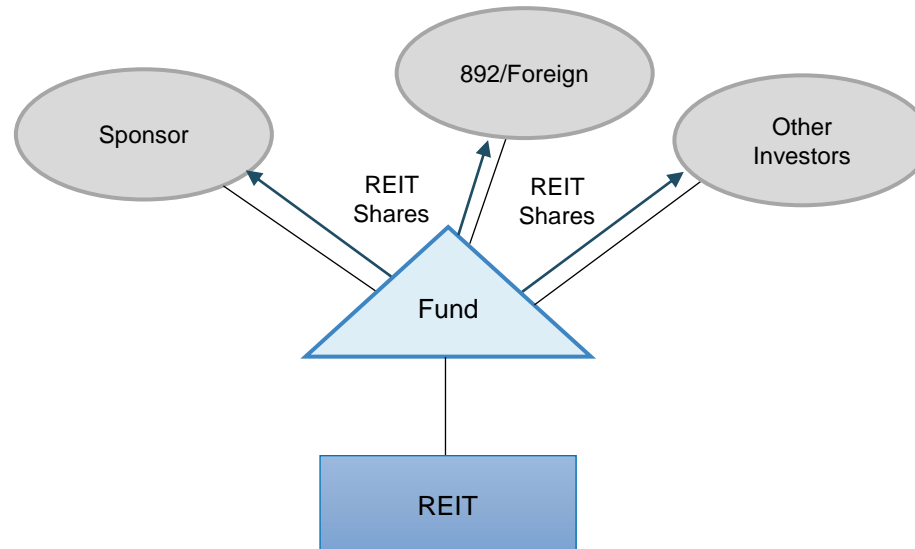
Real Estate Funds (Cont'd)

- Regular way foreign investors will want to exit through a sale of shares in a domestically controlled REIT, raising the same tensions as Section 892 investors.



Real Estate Funds (Cont'd)

- Potential Solution: Although property distributed with respect to an API keeps its API taint (i.e., subject to Section 1061(a)) until it has been held three years, the distribution itself does not accelerate recognition of gain. If an investor wants to make an exit through a sale of REIT shares prior to 3 years, it may be possible for the API holders to take an in-kind distribution of REIT shares that they can continue to hold until the 3 year mark is hit.



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