


Marcus & Millichap

Memorandum

To CCIM - Austin Chapter
From Bradley H. Bailey, Associate Vice President, Investment 
Subject Potential Change to Tax on Carried Interest
Date June 1, 2010

The "Carried Interest" Issue

In spite of a very aggressive campaign by numerous professional commercial real estate groups to oppose a carried interest tax increase, the U.S. House of Representatives voted 215-204 to pass H.R. 4213, which, effective January 1, 2011, will tax the "carried interest" proceeds of real estate partnerships and LLCs at 50% ordinary income and 50% long-term capital gains for two years, then move to a 75/25 split (75% ordinary). This is the fourth time the House has approved a carried tax increase since 2007. Originally targeted at hedge funds, the real estate community will feel an unintended affect.

The Senate is expected to return to Washington June 7 to take up the legislation. The Senate is our last chance to stop the carried interest increase. Next week's upcoming Congressional recess gives us another shot to reinforce our message. From May 31 to June 6, your Senators will be back in their home states. Please take advantage of this Congressional recess by meeting with your Senators to discuss the impact that this tax increase will have on the shopping center industry, your business and your local community.

Congress has been looking at this issue for several years but there is currently increased urgency because of the federal deficit, etc. If passed, it is estimated that 25% of the real estate owned in the US would be affected by this tax change.

A simple example of carried interest happens when a developer establishes a partnership to fund a development and takes an "interest" in the partnership as part of his compensation for putting the deal together. As an example, assume we are discussing a \$5 Million development deal and the developer took 15% of the deal. This \$750,000 of ownership interest is "carried" from year to year until such time as the asset is sold. For this example let's say the asset is sold in year ten.

Under current law, the developer can claim this carried interest as a long-term capital gain and his tax at current LTCG rates is 15% or \$112,500. The argument of policy makers is that the developer did not invest any "capital" (he just took an interest) and, therefore, the gain should be treated as ordinary income. Tax rates vary from individual to individual, but a 35% ordinary tax rate in this example would be typical. If Congress passes the current legislation, the developer would have to pay ordinary taxes of \$262,500 versus the LTCG tax of \$112,500. This represents a 133% increase in the developer's taxes.

Feel free to contact me for more information about this issue at (512) 338-7800, Ext. 7855.

+Reference your trade organization web site for information: ICSC, NMHC, NAIOP and CCIM.