Taxation of Carried Interests

The term "carried interests" was coined in the 16th century to describe a bonus payment to sailing ship captains, and it seems the IRS has been trying to figure out how to tax such arrangements since. Of course in current parlance, the term refers to the promote received by a manager of a hedge fund or private equity deal. In more traditional real estate transactions, the arrangement can take the form of a grant of an ownership piece with participation in future profits, often referred to as a "sweat equity" arrangement. The point being is that pure investors are in the deal as just that – passive investors – while the more active partner is working the deal and contributing with personal efforts to earn some part of the upside. There is quite a bit of variety in how transactions are arranged, so it is dangerous to generalize too much, but that paints the broad picture.

The issue is and has been, what is the character of the income earned? The IRS has long tried to suggest that the income is ordinary and, further, has wanted to accelerate the timing of reporting the income to the date the interest is received, not when profits are paid out. Now it seems every politician in the world is trying to at least get the income characterized as ordinary earned income rather than the more beneficial capital gain. As noted, the typical real estate deal may have an arrangement that varies quite a bit from the Wall Street set up, but likely any rule changes intended to go after the highly publicized carried interest arrangements will bring many typical real estate arrangements under their coverage as well.

The basic idea out there is if you make personal efforts in a business transaction (not a passive investor) and you receive some form of payment, direct or through a participation in profits, then that should be taxable to you as ordinary earned income. It is worth noting that the IRS has gone after such arrangements for many years and has generally only been successful in making their case in the most egregious of transactions.

Of course, it is not unusual for a partner to be paid directly for services and have the transaction reported similar to a payment for services to a non-partner, as earned income (salary or fee for services). The issue is regarding the part of payment that is styled as a share of partnership profits. Currently, the rules support treating the profit share just as it would be for a passive investor: retaining the character of the income as determined at the partnership level. The statute does provide that the IRS can recast a transaction that is more appropriately styled as payment for services, "not in the capacity as a partner." This is not new, but, as noted, is only successfully applied in unusual situations.

The IRS recently issued proposed regulations in support of the referenced provision of the statute that generally provides that an arrangement will be recharacterized if the person receiving the payment lacks business risk regarding the payment. I would say that any payment dependent upon achieving a profit from business operations or the increase in value of partnership assets would have the requisite business risk to avoid recharacterization. If a partner has certainty in the payment being made and is providing services to the partnership, then they start to get into the territory where the income could be restated by the IRS. It is worth reviewing your existing arrangement to see if you may run the risk of being recast under the regulations --- I think it would be fairly simple to revise the arrangement to avoid the application of the regulations.

This is another example of the IRS trying to accomplish through regulations what really should be done through legislation. On that front, politicians have been touting a rule change in this area for so long that perhaps it will get traction (that is if any tax legislation can survive the current political environment). The take away is that a review of your current arrangements is certainly in order to avoid potential problems down the road and to verify you don't have an issue now. Also, there are often unintended business consequences to sweat equity arrangements, so a review with that in mind can be useful as well.

The information in this newsletter was gleaned from a number of sources. If you have a particular question, or would like a citation to the source, please contact Zane Dennis at zane@richeymay.com or 303-721-6131.