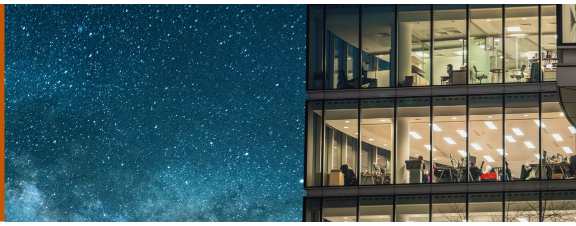
JO Knows How Carried Interests Affect Real Estate



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Let's start with the definition of a carried interest. A carried interest is an ownership interest in a partnership or LLC that shares in the entity's profits. They are typically given in connection with a performance of services. Carried interests have been used in real estate for years. They are a way for a partner/member who is typically the boots-on-the-ground or the person who brought the investors together or who brought the land into a development deal to earn an additional return beyond their capital interest.

To take this a step further and get a little technical (because this is an important factor, especially with real estate), a carried interest is a holder of an applicable partnership interest (API). An API is a partnership interest held in connection with the performance of substantial services by the taxpayer in an applicable trade or business. An applicable trade or business is any activity conducted on a regular, continuous, and substantial basis which consists of raising and returning capital and either investing in specified assets or developing specified assets.

What does that mean? It means that if you are not in the business of raising and returning capital, your interest may not be considered an API and therefore not subject to the rules below.

For years carried interests were taxed at capital gains rates and followed the typical holding period of one year to receive the preferred long term capital gain rates. There have been some changes to these rules over the past few years and there is new reporting starting in 2021.

What Has Changed

The Tax Cuts and Jobs Act (TCJA) made changes to the holding period to receive the long term capital gain rates. Holders of an API must now hold their interest for three years in order to be taxed at long term capital gains rates. This is a major change for those holders of an API and they need to be acutely aware of that holding period because the current difference between capital gains rates and ordinary income rates are substantial.

There are new reporting requirements related to carried interest holders that must be reported on the K-1s that are distributed out to the investors starting in 2021. These reporting requirements provide several key pieces of information needed by the investor to determine any reclassification of any gain reported out to them. These rules are complex and should be followed with caution.

The Section 1231 Carveout

One very important distinction that has been made which is immensely important to the real estate industry is the special carve out for Section 1231 gain. These carried interest rules apply to capital gains but not to Section 1231 gains. Section 1231 gains result from the sale of property used in a trade or business which includes rental real estate. This means that if you have an asset that generates Section 1231 gains, the holding period remains at one year to obtain long term capital gain treatment.

These new rules and the necessary reporting are complex, and you should have someone in your corner that understands these rules so you can be positioned to obtain the best tax rate available to you. We understand these rules and are here to help. To learn more about Johnson O'Connor's Real Estate services, click **here**.

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