“Carried Interest” Legislation: Impact and Alternatives for REIT Equity Compensation

On May 11, 2009, the US Department of Treasury released the General Explanations of the Obama Administration’s Fiscal Year Revenue Proposals (the “Green Book”), which explains the tax provisions of President Obama’s proposed budget for fiscal year 2010. The Green Book includes a summary of President Obama’s proposal with respect to the tax treatment of partnership interests held by partners providing certain services, the so-called “carried interest” legislation.

President Obama’s proposal is similar to (and arguably broader than) the bill introduced by Representative Sander Levin on April 2, 2009 (H.R. 1935) regarding the tax treatment of carried interests, and the previous bill introduced by Representative Levin and Representative Barney Frank which was approved by the House Ways & Means Committee and the full House of Representatives in the 110th Congress. A bill has not been introduced in the Senate yet; however, Senate Finance Committee Chairman Max Baucus held three hearings on the subject during the 110th Congress.

All versions of the legislation generally apply ordinary income tax rates to income received by partners who perform certain services for the partnership. Under the proposals, income representing a return on invested capital will continue to be taxed at capital gain rates.

President Obama’s Proposal

President Obama’s proposal would be effective for taxable years beginning after December 31, 2010 and would apply to all partnerships. Under the proposal, a partner’s share of income on a “services partnership interest” (SPI) would be taxed as ordinary income rather than capital gain, regardless of the character of the income at the partnership level. The proposal also requires the partner to pay self-employment taxes on the share of income, and any gain recognized on the sale of an SPI would be taxed as ordinary income rather than capital gain.

An SPI is a carried interest in the partnership held by a partner who provides services to the partnership. To the extent that a partner who holds an SPI also contributes capital to the partnership and the partnership allocates its income and loss between the invested capital and the remaining interest, income attributable to invested capital would not be treated as ordinary income. Any gain recognized on the sale of an SPI that is attributed to invested capital would continue to be taxed as capital gain. However, invested capital that is attributable to the proceeds of any loan or other advance by the partnership or any other partner would not be treated as “invested capital” for purposes of receiving capital gain treatment.

In addition, President Obama’s proposal includes an anti-abuse rule designed to prevent attempts to circumvent the proposal by using compensatory interests other than partnership interests for service providers. Under the proposal any person who performs services for an entity and holds a “disqualified interest” in the entity will be subject to ordinary income tax on any income received with respect to the interest. A “disqualified interest” is defined under the proposal as convertible or contingent debt, an option, or any derivative instrument with respect to the entity other than partnership interests and stock in certain taxable corporations. The Green Book indicates that the proposal is not intended to adversely affect the qualification of a real estate investment trust owning a carried interest in a real estate partnership.

Effect on REIT Compensatory Profits Interests

As currently proposed, the legislation would generally affect profits interests commonly issued by REITs as compensation to their executives and other service providers (often referred to as “LTIP” awards in the operating partnership). The legislation would result in the income and gain attributable to
the profits interests being taxed at ordinary income rates rather than the capital gain rates that currently apply to much of the income and gain on these interests. In anticipation of the enactment of this or similar legislation, many REITs are considering and inquiring about alternatives to compensatory profits interests which offer at least some capital gain treatment with respect to the equity awards.

While it is true that the tax treatment of compensatory profits interests is generally more favorable than other equity-based compensation under current tax rules, depressed stock prices may provide REITs with an opportunity to utilize other types of equity awards that afford at least some capital gain treatment. For example, restricted stock in the REIT could be granted in lieu of profits interests. If the recipient of the restricted stock makes an election under Section 83(b) of the Internal Revenue Code to be taxed on the value of the restricted stock at the time of grant (subject to ordinary income tax rates), any subsequent gain on the shares of stock will be taxed as capital gain. REITs could also take advantage of lower stock prices to issue incentive stock options (ISOs) at an exercise price equal to current share values. Provided that the ISO complies with the requirements for statutory stock options under the Internal Revenue Code, any gain in the value of the stock above the exercise price should generally be taxed as long-term capital gain. Although ISO treatment is limited to the first $100,000 worth of option shares that vest for the first time in a given year, the value of the shares is measured as of the date of grant (rather than the date of vesting). Consequently, today’s lower stock prices will enable a greater number of option shares to be eligible for the more favorable capital gain treatment.

In addition, traditional equity-based compensation that does not offer any capital gain treatment may be preferable to profits interests that are taxable at ordinary income rates. Because profits interests require that the recipient be treated as a partner of the operating partnership for other purposes, including making estimated tax payments, partner tax filings in multiple jurisdictions, and possibly employment taxes and employee benefit plan participation, REITs may wish to reconsider equity awards such as nonqualified stock options, restricted stock units, restricted stock grants (without a Section 83(b) election) and other equity-based awards under the REIT’s equity incentive plan. These awards may be desirable even with respect to individuals who are already partners by virtue of prior awards of profits interests, since they offer a more simple and straightforward approach for new grants going forward.

Latham & Watkins is monitoring the development of proposed legislation regarding the taxation of partnership interests. Please contact David Taub at +1 213.891.8395, Michael Brody at +1 213.891.8724 or any member of the Latham & Watkins Benefits and Compensation Group listed below if you would like additional information regarding the legislation or equity-based compensation arrangements at affected companies.

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