NAR Issue Summaries

Federal Tax / Capital Gains -- Carried Interests

NAR Committee:

Federal Taxation Committee

What is the fundamental issue?

Policy makers from both parties, including President Biden and various Members of Congress, have proposed changing the tax treatment of a general partner's carried interest from long-term capital gains income to ordinary income. Long-term capital gains tax rates are much lower than ordinary income tax rates.

Many real estate partnerships are organized with general partners, who contribute their expertise (and, occasionally, some capital) and limited partners who contribute money and property (capital) to the enterprise.Generally, any profits of the partnership are divided among the limited partners who contribute capital.A common practice among real estate partnerships, however, is to permit the general partner to receive some of the profits through a "carried interest," even when the general partner has contributed little or no capital to the enterprise.The general partner's profits interest is "carried" with the property until it is sold.

During the time that the real estate is held, the general partner usually receives compensation in the form of fees that are taxed as ordinary income.The limited partners receive both ordinary income from operations and capital gains income from any profits generated during the year.When the property is sold, the limited partners receive their profits distributions (the earnings on the capital they have invested) as capital gains.In most cases the general partner also receives the value of any carried interest as capital gains income.

I am a real estate professional. What does this mean for my business?

A residential real estate sales agent and/or broker will not generally be directly affected by the proposal, as it applies only to real estate investment partnerships that have carried interests.Real estate brokerages are rarely, if ever, organized in that model.

Real estate investment, however, is typically held in partnership (or LLC) form.Not all partnerships include both general and limited partners or carried interests for the general partners, but real estate investments that are held in that form would be harmed by the proposal.By increasing the tax burden on these real estate partnerships, and particularly on those with operational expertise, the proposal would make real estate a less attractive investment.When the value of real estate investment is impaired, there is a negative indirect impact on all real estate.

NAR Policy:

NAR opposes any proposal that would eliminate capital gains treatment for any carried interest in a real estate partnership.

Utilization of the carried interest mechanism for real estate partnerships is a standard operating practice that has not, historically, been seen by either courts or policy makers as a “loophole."Rather, capital gains treatment for income from a carried interest is seen as a reward for entrepreneurs (general partners, in this case) who take the risks inherent in new projects and in making capital investments. Capital gains treatment of carried interests also mitigates the impact of inflation on a long-term investment.

Opposition Arguments:

Opponents of NAR policy will say that high-earning taxpayers should pay their "fair share" of taxes and that their tax rate on any carried interest profits should be taxed like salary or other earned income. The past several presidential election campaigns highlighted the divide between those who believe that Wall Street high-rollers such as certain hedge fund and private equity fund managers should pay ordinary income tax rates on income from carried interests and those who believe the tax law should provide incentives in the form of lower tax rates for those who risk their time and capital in risky long-term investments.Opponents also believe that capital gains treatment for carried interests favor higher-income taxpayers over those of more modest means, who usually do not have access to investment vehicles that offer a carried interest.

Legislative/Regulatory Status/Outlook

The Tax Cuts and Jobs Act of 2017 did narrow the rules for qualifying for capital gains taxation for owners of carried interests by requiring that assets subject to the rules must be held for at least three years. However, this change was viewed by many as not harming real estate enterprises because real estate is held for longer than three years in most instances. More recent proposals to tax carried interests as ordinary income would be more harmful to real estate investment.

There are still Members of Congress who would like to further limit the rules, but it is unclear if or when these changes might move toward enactment.

Current Legislation/Regulation (bill number or regulation)

None at this time.

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