# Tax Cut and Jobs Act Limits Benefit of Carried Interest

Article
03.02.2018

Related Expertise

Tax

After many years of being the target of Congress and the IRS, the Tax Cut and Jobs Act finally succeeded in limiting the beneficial tax treatment of carried interests, at least for some taxpayers. This change will be of particular impact to taxpayers such as real estate developers and real estate fund sponsors.

**1. What is carried interest?**

Normally, when an employee does work for his employer, the employee includes his compensation in his taxable income at ordinary income rates. In the partnership area, though, a manager or other person that provides services to the partnership can agree that part of his compensation will be a share of profits. For example, after the investors receive a specified return of their investment, the manager will receive 20% of any profits over that threshold. This 20% would be a carried interest.

**2. How was carried interest taxed before the Tax Cut and Jobs Act?**

The receipt of a carried interest is not generally taxable. Instead, it is only when the partnership actually recognizes and allocates the 20% of profits that the carried interest is taxable to its holder. Moreover, if the partnership is generating capital gains (for example, on the sale of real property), the income allocated with respect to the carried interest qualified for capital gain treatment.

**3. How does the Tax Cut and Jobs Act change the treatment of carried interest?**

Where the new rule applies, the holder of the carried interest must have held his carried interest for at least three years. If the three year holding period is not satisfied, the income allocated with respect to his carried interest will be treated as short term capital gain (taxed at ordinary income rates), even where the income would otherwise qualify as long term capital gain.

**4. What partnerships are subject to this rule?**

This rule applies to partnerships that primarily hold assets such as real estate for rental or investment purposes, cash or cash equivalents, securities, commodities, options and derivate contracts.

**5. Are there exceptions to this rule?**

If the carried interest is paid to a corporation, the three year rule does not apply. There has been some discussion whether a taxpayer could hold his carried interest through an S corporation and thereby avoid this rule. The IRS issued a proposed regulation that asserts that S corporations do not qualify for this exception. Whether the IRS has the authority to take this position and issue this regulation in light of the specific language in the Tax Cut and Jobs Act is questionable.

---

This article is informational only. You should consult an attorney before acting or failing to act. The law may change rapidly and no warranty is given. LOWNDES DISCLAIMS ALL IMPLIED WARRANTIES AND WITHOUT LIMITATION, ANY WARRANTY OF FITNESS FOR A PARTICULAR PURPOSE. ALL ARTICLES ARE PROVIDED AS IS AND WITH ALL FAULTS. Consult a Lowndes attorney if you wish to establish an attorney/client relationship.