International Council of Shopping Centers

ISSUE PAPER

Taxation of Carried Interest

- In 2005, 46% of the partnership tax returns filed with the IRS were for real estate partnerships.
- The estimated economic loss due to the crowding out of economically-viable projects is between $15 billion and $20 billion annually.

Position: ICSC strongly opposes the proposed changes to the taxation of carried interest. These potential changes do not acknowledge the entrepreneurial risk and personal guarantees that the managing partner offers on behalf of the real estate partnership. By undercutting the economic incentive to build a project or redevelop an underutilized property, this change could significantly drive away investment from the commercial real estate sector when it is most needed.

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Background: The President's budget plan proposes to increase the taxation of carried interest from the current and more favorable capital gain rate of 15% to the higher ordinary income tax rate of 35%. This increase will dramatically change the way real estate partnerships have operated for more than 50 years, as most real estate ventures are organized as limited partnerships, with the general partners' interest treated as compensation for services. As a result, while the stated intent of this proposal is to address the perceived tax rate inequity applied to private equity and hedge fund managers, it will disproportionately impact the real estate industry.

Unlike private equity firms, the carried interest for the general partner in a real estate partnership is not guaranteed income. Most real estate partnerships must exceed numerous hurdles, which result in the limited partner realizing a return on investment before the general partner sees the first dollar of gain. Moreover, the general partner often experiences a significant "hold" time before seeing that gain.

By treating the general partner's interest in a partnership as compensation for services, the risk that the general partner undertakes on behalf of the partnership is not recognized. The direct risks include all partnership liabilities for environmental concerns, lawsuits, loan guaranties and carve-outs. Furthermore, the general partner is currently required to pay ordinary income taxes on the fees received from the partnership for standard services such as leasing or construction management.

Current Activity: In June 2007, legislation was introduced by Congressman Sander Levin (D-MI) to tax general partner capital gains not related to direct financial investment as compensation received for performing services. In the 110th Congress, the U.S. House of Representatives twice passed this measure. In February 2009, President Obama included the increase in the taxation of carried interest for all partnerships in his 2010 Budget.

Rationale: ICSC members have been willing to take risks in order to bring products and services where they are needed. They invest in communities, whether it's a new development in the suburbs, revitalization of an old downtown business district or renewal of a dated shopping center. However, if the proposed tax increase is enacted, economic development in the most underserved areas will likely become too big a risk to undertake. This disruption in real estate development will threaten jobs and economic growth that are critical to local communities nationwide.

Summary: Any change in partnership tax rules will have a tremendous impact on many small businesses, especially in the real estate industry. During this time of economic recession, Congress should encourage investment in our communities and reject the proposed tax changes. This increase is not just a tax issue; it is an issue of job creation, economic recovery, and revitalization of communities across the country. Therefore, ICSC opposes efforts to increase the taxation of carried interest.