



International Council
of Shopping Centers

ISSUE PAPER

Taxation of Carried Interest

- According to the IRS, real estate partnerships represented 48% of partnership tax returns in 2007.

- 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 proposed changes to the taxation of carried interest. This potential tax increase does not recognize 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: HR 4213, the tax extender package, uses an increase in the tax rate of carried interest from the current and more favorable capital gain rate of 15% to the higher ordinary income tax rate of 35% to offset the extensions. The 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. While the original 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: The carried interest tax increase was included as part of the tax extenders package (H.R. 4213) that was passed by the U.S. House of Representatives on May 28, 2010. The Senate has previously expressed its intent to consider this issue along with the larger tax reform debate. 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 jobs and small businesses, especially in the real estate industry. During this time of economic recession, Congress should encourage investment in our communities and reject this job-killing tax change. 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.