



The Issue:

Congress has proposed dramatically changing the way real estate partnerships have operated for decades. Lawmakers are asserting that the general partner should be taxed at the higher ordinary income tax rate on the general partner's interest in a partnership as compensation for services, rather than the current and more favorable capital gain rate applied to the limited partner's interest.

While the stated intent of this legislation is to address the perceived tax rate inequity applied to the extreme profits being realized by private equity and hedge fund managers, this legislation will directly impact the real estate industry as most real estate ventures are organized and taxed as limited partnerships. In 2005 the Internal Revenue Service reported that 2.8 million partnership tax returns were filed. Of those filings, 1.3 million were for real estate partnerships, representing 46% of the partnership tax returns.

In June 2007, Congressman Sander Levin (D-MI) and other majority members of the Ways and Means Committee introduced H.R. 2834, legislation to tax general partner income not related to direct financial investment as ordinary income (35%) as compensation received for performing services. This legislative language has been included by Ways and Means Chairman Charlie Rangel (D-NY) as a revenue raiser for legislation to fix the unintended impacts of the Alternative Minimum Tax and may be proposed as an offset for other legislation in 2008.

ICSC members are focused on investing in communities, whether it's a new development in the suburbs, revitalization of an old downtown business district or breathing new life into a dated shopping center. ICSC members have been willing to take risks in order to bring products and services where they are needed. If the proposed change to the taxation of carried interest becomes law, economic development in the most underserved areas could become more difficult.

Our Position:

ICSC strongly opposes the proposed changes to the taxation of carried interest because it does not acknowledge the "entrepreneurial risk" that the managing partner accepts 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 into the commercial real estate sector.

Furthermore, unlike some hedge funds or private equity firms, the carried interest for the general partner is not guaranteed income. Most real estate partnerships must exceed significant "hurdles," allowing the limited partner to realize return on investment before the general partner sees the first dollar of gain and usually after a significant amount of time. ICSC has undertaken an educational campaign with other impacted groups to provide information to lawmakers regarding the far-reaching consequences of this legislation.

Opposing Argument:

Supporters of the legislation claim that the general partner's carried interest, or share of the profits, is really a payment for services rendered and should be taxed as ordinary income in the name of tax fairness.

ICSC's Response:

The general partner pays ordinary income taxes on the fees received from the partnership for services such as leasing or construction management. However, the carried interest represents the risk that the general partner undertakes on behalf of the partnership. In addition to lost opportunity costs, the direct risks include the partnership liabilities for environmental concerns, lawsuits, loan guaranties and carve-outs.