

Oppose Raising Taxes on Real Estate Partnerships

As part of legislation to extend bipartisan tax provisions (“tax extenders legislation”), the House of Representatives included a controversial provision to tax partnership carried interests as ordinary income instead of as capital gains. In the real estate industry, a “carried interest” (also known as a “promote” or “promoted interest”) is a financial interest in the appreciation of a property given to the developer by the investors. It allows the developer to share in the “upside” of the real estate venture, and compensates the real estate entrepreneur for substantial risks taken during development of the project and during the period prior to sale of the property. While a carried interest tax hike has most often been characterized as affecting Wall Street hedge fund managers, it would in fact have a major impact upon real estate development partnerships. The provision would more than double the tax rate, from a current capital gains rate of 15 percent to ordinary income rates as high as 35 percent on many real estate partnerships, at a time when the commercial real estate industry is struggling.

Given as a return for risk, and not guaranteed income.

A carried interest is given by the limited partners in a real estate partnership to the general partner (usually the developer) in return for the risks taken by that partner during the project. A general partner will often personally guarantee construction completion of the project, as well as payment of all debts of the partnership. In addition, the general partner is at risk for all partnership liabilities such as environmental contamination and other lawsuits.

A carried interest oftentimes cannot even be valued at the time it is granted since its payment is contingent upon the ultimate success of the project. Therefore, a carried interest is *not* guaranteed salary income to the general partner for services. It is more in the nature of a *long-term risk investment* that should be treated as capital gains. Fees received by the general partner for services provided are already taxed as ordinary income.

Development results in the creation of capital assets

Real estate development, unlike other industries where carried interests are used, results in the creation of a tangible, capital asset - a shopping mall in a community, an office building, a housing project, or an industrial development. The carried interest is given for the risks taken in the creation of this capital asset, which also gives rise to jobs and results in an increased tax base for the community.

An increase would undermine economic activity, and decrease investment in real estate

A tax increase on carried interest would undermine entrepreneurial activity in the real estate development industry. If the willingness to take development risk is reduced by much higher taxes on the ultimate return, then many job-creating development projects will simply not be undertaken and local economic development efforts will be undermined.

Carried interest legislation would be retroactive

The carried interest provision of the extenders bill is retroactive, with no transition rules, and applies to any structures currently with a carried interest component. This would unfairly punish many entrepreneurs who entered into deals with the expectation that the reward, if any, for the risk taken in developing a real estate asset would be treated as a capital gain.