NMHC National Multi Housing Council®

NATIONAL APARTMENT ASSOCIATION

Issue Fact Sheet

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TAXATION OF CARRIED INTEREST

Background

In 2007, the House of Representatives initiated an effort to rein in the high-flying hedge fund managers by proposing to eliminate capital gains treatment of carried interest and taxing it as regular income instead. However, the reach of this proposal goes much further and, if enacted, will significantly reduce the ability to develop or rehab apartments across the nation.

Real estate partnerships—and many of the 618,000 workers and 17 million Americans who rely on our industry to provide them with safe, decent affordable housing—will be adversely affected by such a change. At a time the Harvard University Joint Center for Housing Studies estimates that the nation already faces a 3 million unit shortage of affordable rental housing, increasing the tax rate on long-term capital gains will discourage real estate partnerships from investing in new construction. Furthermore, such a reduction will translate into many fewer construction, maintenance, on-site employee, and service provider jobs at a time our economy is struggling under the weight of an abnormally high unemployment rate.

A "carried interest" (or "promote") has been a fundamental part of real estate partnerships for decades. Investing partners grant this interest to the general partners to recognize the value these partners bring to the venture as well as the risks (recourse debt, litigation risks, responsibilities for cost overruns, etc.) they take.

Current tax law, which treats carried interest as a capital gain, is the proper treatment of this income because carried interest represents a return on an underlying long-term capital asset, as well as risk and entrepreneurial activity. Extending ordinary income treatment to this revenue is inappropriate. In addition, any fees that a general partner receives that represent payment for operations and management activities are already properly taxed as ordinary income.

The proposed change in the taxation of carried interest would impose the most sweeping and potentially most disruptive new tax on real estate since the Tax Reform Act of 1986, which contained the passive loss limitation rules.

Not only is such a tax law change inappropriate, it will also have numerous unintended consequences, including exacerbating the nation's affordable housing shortage. If enacted, changes in the taxation of carried interests could affect whether a new development is financially viable. It will be particularly damaging to properties located in under-developed areas and could prevent much of the proposed new affordable housing from being built.

For these reasons, in 2010 both the U.S. Conference of Mayors and the National Association of Counties passed resolutions opposing this proposal as it relates to real estate partnerships and urged Congress to maintain the current law-capital gains treatment of "carried interest," noting that any change would bring extremely negative consequences to "main streets" throughout the country.

Finally, some in Congress see the tax revenue generated by the carried interest proposal as a way to offset the cost of other tax changes, such as changes to the alternative minimum tax or tax reform more generally. Enacting a bad tax law, such as carried interest, merely to gain revenue to make other tax changes, is not an appropriate view of tax policy, which demands that each tax proposal be judged on its individual merits.

NMHC/NAA Position

NMHC/NAA strongly oppose proposals to change the current law governing the tax treatment of carried interests. A carried interest or "promote," which has been a fundamental part of real estate investment partnerships for decades, is an interest in the long-term capital gain of the partnership when it sells its property. Investing partners grant this interest to the general partners as an incentive for increasing the value of the underlying asset. The distribution of funds when a partnership is terminated come from the sale of capital assets, making capital gains, which recognizes the long-term nature of real estate investing, the proper tax treatment for carried interests.

Current Status

Congress considered legislation to change the tax treatment of carried interest during the 111th Congress (2010), but the measure never made it through the Senate. The carried interest proposal reemerged in the summer and fall of 2011 as part of the debate over legislation to raise the nation's $14.3 trillion debt ceiling and then as the Joint Select Committee on Deficit Reduction ("Super Committee") created as part of that process sought to identify $1.5 trillion in deficit reduction. Although the Super Committee failed to generate a proposal, carried interest could well be on the table in the future as Congress looks to fund the cost of other initiatives. For example, the White House has proposed using a carried interest tax increase to offset the President's job creation package offered in September 2011 and once again included it in its Fiscal Year 2013 Budget released in February. At this point, NMHC/NAA are working to ensure policymakers understand the devastating impact that any modification to the tax treatment of carried interest would have.

Relevant Committees

Senate Finance
House Ways and Means
Joint Committee on Taxation

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