

SUPPORT ECONOMIC MOBILITY, ENTREPRENEURIAL RISK-TAKING, AND AMERICA'S REAL ESTATE

August 3, 2022

Dear Senator:

The undersigned organizations represent a broad and diverse spectrum of America's real estate industry. We write to oppose the carried interest provisions of the Inflation Reduction Act of 2022 which would harm the residential and commercial real estate industries to the overall detriment of job creation and the economy.

The carried interest proposal would slow housing production, discourage the capital needed to reimagine buildings to meet post-pandemic business needs, hamper job creation and create an additional unknown in an already confusing economic environment. The small amount of revenue associated with the proposal is not needed in this inflation-fighting legislation and we respectfully urge that it be dropped.

Although the bill excludes real estate businesses from the 5-year holding period, it includes other substantive changes to carried interest that would harm real estate. Specifically, we are concerned with:

- **Holding period measurement.** The legislation would unintentionally extend the holding period requirement well beyond the 3 or 5 years suggested in the bill's description. Some real estate assets that are held for 8 years, 10 years, or even longer would not qualify for long-term capital gains treatment. This is because the holding period would not start until a partnership had acquired substantially all of its assets. In the case of an open-ended fund that has no predetermined end date, it may *never* meet the holding period's "substantially all" requirement.

As a result, the bill would greatly distort and misalign the interests of general partners vis-a-vis limited partners who are not subject to these arbitrary rules. It would drive the potential for new and unnecessary conflicts between parties. In addition, the holding period changes would unfairly deny capital gains treatment to the income that arises from many productive, long-term investments simply because of the owners' partnership structure. The fact that a partnership invests in more than one building or business should not distort the basic economic reality and longstanding principle that each asset is taxed at its own capital investment with its own lifespan and holding period.

Even in the case of a partnership that is developing just one property, the amount of time required to meet the holding period could significantly exceed three years because the clock would not start until the asset is actually placed in service. In the case of a new housing development, for example, a general partner would not be credited with the lengthy amount of time spent on the predevelopment, entitlement, and construction phase, despite the financial expense and risk borne during this critical period of the project.

Lastly, a taxpayer that acquires an interest in a partnership should measure his or her holding period based on when the interest was acquired.

- **Extension to section 1231 gain common in housing and other real estate projects.** The legislation, perhaps unintentionally, would extend the holding period requirement to other types of carried interest income common in the construction and improvement of housing and other real estate. Specifically, the expanded carried interest rules would pull in section 1231 gain — net gain from property used in a trade or business or held for the production of income. Section 1231 gain was excluded from the regime when it was enacted in 2017. Many real estate funds construct or rehabilitate housing and sell it within two years so they can finance the next housing project. Extending the 3-year holding period will slow down their housing development as funds hold on to the property for another year, or it likely will drive up rents on the property to recuperate the additional tax liability. The proposed change is counterproductive to addressing the severe housing and crisis throughout the country.
- **Retroactivity.** The legislation would apply retroactively to partnership agreements executed years earlier. In some cases, the result would be to change the tax rate for one partner to the agreement and not the others. This could alter the basic and mutually agreed economics of the original deal between the parties, and further undermine the predictability of the tax system.

Carried interest is a vital tool contributing to capital formation and new housing development, productive risk-taking, and job creation. The COVID-19 pandemic and other trends have generated significant shifts in the demand for commercial real estate and how buildings are used, including residential housing. Today and continuing over the next several years, buildings throughout the country will need to be reimaged, repurposed, and converted to a new use in the post-pandemic era. Carried interest helps mobilize investment by allowing cash-poor entrepreneurs to partner with passive investors to collectively plan, finance, and develop housing and other new projects. These real estate partnerships drive the construction and rehabilitation of affordable, workforce, and senior housing; the build out of public infrastructure, including electric vehicle charging stations; and environmental remediation of land and development of renewable energy projects like wind and solar farms.

Changes to carried interest could have profound, unintended consequences for the main streets of cities all across our country. Property taxes on real estate contribute 75 percent of local tax revenue and provide a stable and reliable source of funding for vital public services like education and law enforcement. A 2021 study by USC Professor Charles Swenson found that taxing real estate carried interest as ordinary income would reduce state and local tax revenue by over \$26 billion.

The Swenson study also found that increased taxes on carried interest could result in over 1.7 million long-term job losses in real estate. Similarly, other studies have found that carried interest legislation would result in reduced housing construction activity, lower property values, and decreased wages in the real estate industry. Limiting capital gain treatment only to taxpayers with their own deep pockets would reduce economic mobility by increasing the tax burden on less-advantaged entrepreneurs

At a time of economic uncertainty and housing shortages, lawmakers should avoid enacting policies that create new and unnecessary tax barriers to capital formation and real estate investment.

As a matter of pure tax policy, the tax code has never, and should never, limit the reward for risk taking to taxpayers who have cash to invest. An entrepreneur who foregoes the security of a salary in order to invest their time and effort into starting a business that may or may not succeed should qualify for capital gains treatment the same way that a deep-pocketed and passive investor qualifies when they put their cash into a public stock or private venture. In particular, minority and women-owned businesses that may not have access to cash to expand and grow would be at a disadvantage to more established, capital-secure businesses.

Most partnerships in all businesses reward the general partner with a share of the ultimate capital gain that reflects the risk they have taken—equity capital, assumption of business risk, or through good old-fashioned sweat equity. Reward for these latter forms of risk is “carried interest.”

In real estate, success is measured largely by whether there is appreciation of the property. Successful owners work hard over a period of years to increase the attractiveness of the building, provide more and better services to tenants, and create value even as macro trends may otherwise push prices up or down. Under current law, this appreciation is long-term gain for all partners. Why would an owner undertake this effort if the tax law did not recognize it for what it is—an enhancement of the value of the asset?

General partners receive fees for routine services like leasing and property management. Those fees are taxed appropriately at ordinary tax rates. The carried interest is granted for the value the general partner adds to the venture *beyond* routine services, such as business acumen, experience, and relationships. It is also recognition of the risks the general partner takes with respect to the general partnership’s liabilities. These risks can include funding predevelopment costs, guaranteeing construction budgets and financing, and exposure to potential litigation over countless possibilities.

Achieving tax fairness is complicated. Simple solutions often are not solutions at all. Now is not the time to impose a tax increase on the countless Americans who use partnerships to develop, own, and operate housing and other commercial real estate. We urge you to preserve current tax law as it relates to carried interest.

American Resort Development Association
American Seniors Housing Association
Building Owners & Managers Association
CCIM Institute
CRE Finance Council
ICSC
Institute of Real Estate Management
Mortgage Bankers Association
NAIOP, the Commercial Real Estate Development Association
National Apartment Association
National Association of Home Builders
National Association of Realtors®
National Multifamily Housing Council
The Real Estate Roundtable
Realtors® Land Institute