International Council of Shopping Centers

The Real Estate Roundtable

UNITED STATES SENATE
COMMITTEE ON FINANCE

"CARRIED INTEREST, PART II" HEARING

215 DIRKSEN BUILDING

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STATEMENT OF ADAM IFSHIN ON BEHALF OF THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS AND THE REAL ESTATE ROUNDTABLE*

Thank you, Chairman Baucus and Ranking Member Grassley, for conducting today's hearing on potential changes to the tax treatment of partnership "carried interest".

My name is Adam Ifshin and I am the incoming chairman of the International Council of Shopping Centers' economic policy committee and the co-founder and president of DLC Management Corporation, an owner, developer, and re-developer of shopping centers headquartered in Tarrytown, NY. DLC specializes in revitalizing older properties in in-fill first tier suburbs, cities and some small towns.

Founded in 1957, ICSC is the premier global retail real estate trade association for the shopping center industry. Its more than 70,000 members in over 92 countries include shopping center owners, developers, managers, marketing specialists, investors, retailers and brokers, as well as academics and public officials.

I am appearing today on behalf of the ICSC, the Real Estate Roundtable, and other real estate organizations whose members will be significantly impacted by proposals to tax all carried interests as ordinary income. Simply stated, I believe if such a policy is enacted, it would be the most sweeping and potentially most destructive tax increase on real estate since the modification of passive loss rules of the 1986 Tax Reform Act. The application of those rules to existing real estate triggered unintended consequences, namely the savings and loan collapse, the Resolution Trust Corporation, a credit crunch that caused a major downturn in the real estate industry and cost taxpayers billions of dollars.

I started DLC Management when I was twenty-six years old. I had no money and the commercial real estate industry was struggling to overcome the damage caused by the savings and loan crises and the 1986 Tax Reform Act. Since starting from the ground floor, my company has grown to become one of the nation's preeminent owners and medium-size operators of retail shopping centers with 72 centers located across 25 states. Over the past 16 years, DLC has created value in underserved markets by investing hundreds of millions of dollars in commercial real estate. DLC focuses on the redevelopment of older distressed properties in challenging environments, which often include older in-fill suburbs and cities such as Peekskill, NY, environmentally challenged brownfield properties like Levittown Mall in Tullytown, PA, and underserved rural or multi-ethnic city neighborhoods like Carbondale, IL and inner city Baltimore, MD.

We reinvest most of our capital gains into new projects in order to continue to make long term investments in communities that might not otherwise see revitalization. And I can unequivocally state that my company as it exists today could not have been built if the taxation on gains was at the ordinary income rates proposed by H.R. 2834. The returns simply would not have justified the risk in many cases. A carried interest is the return on the entrepreneurial risk that makes the deal or project happen. Embedded in the DLC business plan is the concept that a material component of the remuneration is the general partner's profit participation, taxed at the capital gains rate.

Here are some illustrations of DLC's achievements of bringing national retailers and new life into towns and properties time long forgot - - these deals were all done in a partnership format with carried interest taxed at the capital gains rate. If current law is changed to tax carried interest at the ordinary income rate, then the investment viability of projects like these will surely be brought into question - - and eventually a disruption in the real estate marketplace will take place.

- Spring Valley, NY – DLC brought Target, Bed, Bath and Beyond, Michaels Arts and Crafts, T.J. Maxx, 9 West and other recognized retailers to a 70% vacant center in a market that is 50% African-American and 30% Latino. Most of the retail had moved out to an upscale mall three miles away, yet through our efforts, the center is now 100% occupied. During this project, 550 construction jobs were created; 650 retail jobs added. DLC paid over $30 million for the center and has spent $12 million in investments, the largest private sector investment in Spring Valley in the past 20 years.

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- Peekskill, NY – DLC totally re-developed a 1950's shopping center where the supermarket anchor and the junior anchor had both gone bankrupt. We brought the first new full service grocery store, a Stop & Shop, to this predominantly minority community in 20 years. Other national tenants include a CVS, Dunkin' Donuts, Dollar Tree and Tuesday Morning. The project produced 600 new construction jobs and 400-450 permanent retail jobs. Our development was 100% privately funded and over four years in the making. DLC paid $14 million for the site and invested $19 million thereafter to redevelop it.

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- Oxon Hill, MD – DLC acquired two underperforming grocery anchored shopping centers in an African-American community. We fully expanded and renovated one center and brought to 100% occupancy, featuring retailers such as Shoppers Food Warehouse, A.J. Wright and Advanced Auto. The rejuvenation of the second center is now underway with new facades, new national tenants and the Giant grocer is renovating and expanding.

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- Levittown, PA – DLC tore down an obsolete 1950's open air mall. This project required major environmental brownfields remediation to address more than one million square feet of asbestos-containing material and 67 underground fuel tanks. Now there is a new center being built featuring a Home Depot, Wal-Mart Supercenter, Ross Dress for Less, Starbucks, Wachovia, Famous Footwear, Dress Barn, Day Care Center and others. Over 1000 construction jobs have been created and 1000 retail jobs. DLC bought the property for $9.5 million and will invest $60 million total, without any public subsidy. This center will be the largest commercial tax payer in the borough.

Despite having structured real estate partnership deals for close to two decades, use of the term "carried interest" was new to me and emerged only when reading recent news reports about Congressional action in this area. In real estate, "carried interest" is typically referred to as the general partner's interest, the "promote", or perhaps the back-end profit participation. Whatever you want to call it, the concept is the same, i.e., the return on the entrepreneurial risk that makes the deal or project happen.

For years, real estate deals have been structured as limited partnerships or limited liability companies (LLCs). Both types of entities are taxed as partnerships. In a typical limited partnership, there will be one or more financial investors as the limited partners and an operator or developer, serving as the general partner. The General Partner brings a combination of intangible assets, assumption of significant risk, and intellectual capital as part of arranging and operating the venture. In exchange, the General Partner receives a share of future partnership profits, typically after the Limited Partners receive a minimum compounded preferred return generally in the range of 8-12% per annum and their initial equity back. The General Partner's profits are a pre-determined percentage of the residual profits that is arrived at after the Limited Partners have attained their required minimum return on the investment.

In addition to a carried interest, the General Partner typically has two other economic interests in the partnership. The General Partner or a related entity receives a non-profit based management fee for performing day-to-day property management services. This is taxed as ordinary income. The General Partner typically also invests capital, side by side with the investor, commonly 1% - 10% of the total capital in the partnership. This is structured as a Limited Partner interest.

Real estate development involves substantial risk to the General Partner, and the financial reward on the back-end is what makes that risk worth taking. Capital gain tax treatment for a long-term commitment to the investment is part of that reward. Of course, that assumes there is a reward in the end. Many real estate developments never get off the ground. Still others fail or fall short of their goals. In all these cases, the General Partner gets nothing other than fees.

The General Partner takes on significant financial risk every time an asset is acquired or deal negotiated. For instance, the General Partner is at risk for recourse loans, personal guarantees and completion guarantees on construction loans, and environmental indemnities for all loans. The General Partner is taking risk beyond its investment in any given real estate project and the carried interest is earned in part for that entrepreneurial risk taking.

Most real estate projects are not short term in nature. Projects frequently take 5-10 years to fully mature from concept to entitlements, to construction, to lease up, and stabilization. If H.R. 2834 were to pass the Congress some development would still occur, but the material shift in the risk/reward trade-off for the developer would mean that fewer projects would be built. Those that would be built would tend to be higher-end, fancier developments in wealthy communities and central business districts where there is less risk. What H.R. 2834 proposes makes underserved and given-up-for-dead locations far less appealing to developers because those deals are harder to put together and have greater risk associated with doing them. The net result will be to cause the greatest harm to those communities that need development and revitalization the most - - communities like Newburgh, NY, Spring Valley, NY, and the West Side of Baltimore, where there is a fundamental lack of shopping alternatives for predominantly minority consumers. A lack of retail options leads to higher prices for basic commodities like milk and bread for those people who can least afford to pay.

Community leaders where we do business fully understand and appreciate the benefits our development brings to their citizens - - more consumer choices at less cost, job opportunities, both at the construction phase and thereafter, an increased tax base and improved quality of life.

- Real estate is a vital part of our national economy contributing, over $2.9 trillion or one third of the Gross Domestic Product. Real estate asset values, residential and commercial, total nearly $20 trillion.

- Real estate creates jobs for over 9 million Americans - - and these are not “off-shored”.

- America’s real estate is the source for nearly 70% of local tax revenues, which pay for schools, roads, police and other essential public services.

- U.S. commercial real estate is worth approximately $5 trillion.

- Almost $250 billion is invested in commercial real estate improvements annually -- with $15 billion of that amount going to leasehold improvements. The impact of this investment doubles as it filters through the economy.

- America’s 50,000 shopping centers account for over $2.25 trillion in sales and generate over $120 billion in state sales taxes.

- Housing accounts for 32% of household wealth. Total single-family (owner occupied) housing is worth approximately $15 trillion, with homeowners’ equity valued at around $8 trillion.

- Publicly traded real estate investment trusts (REITs) have a total equity market capitalization of $355 billion.

- Private investments in commercial real estate done largely through partnerships have a total equity of over $1 trillion.

Conclusion

According to IRS statistics, in 2005, 46% of partnership tax returns came from the real estate industry. This statistic is significant as it clearly shows that “carried interest” applies to many more industries than just the hedge funds and private equity firms with which it is now associated. Any change in partnership tax rules will have a tremendous impact on the short-term future of the real estate industry, an industry that has been a significant economic driver in our nation's economy since 2000. At the end of the day, this is not just a tax issue, it is a major economic issue threatening job creation, economic development, and revitalization of communities across the country.

Chairman Baucus and Ranking Member Grassley, thank you for holding this hearing and for giving me the opportunity to testify. We look forward to working with you as you continue to examine this matter. I welcome any questions.

**Real Estate Trade Association Members of The Real Estate Roundtable*

National Association of Real Estate Investment Trusts
National Association of Realtors
National Association of Homebuilders
National Association of Real Estate Investment Managers
National Multi-Housing Council
National Association of Industrial and Office Properties
Pension Real Estate Association
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