SOUTHEAST REAL ESTATE BUSINESS

THE THREAT OF CARRIED INTEREST LEGISLATION?

One view of current bills in Congress sees an unintended threat to the commercial real estate industry.

Peter Monroe

Until recent federal legislation was introduced, aiming at reducing the profitability of the venture capital industry, most real estate practitioners had heard little of the term "carried interest". Nor had they understood that, if such legislation were passed, it would have profound adverse effects on the commercial real estate development industry — possibly as great as the passive loss provisions of the Bill Bradley–inspired 1986 "Tax Relief Act".

The proposed legislation, H.R. 2834, introduced by Rep. Sander Levin (D-MI) in the House of Representatives more than doubles the tax rate imposed on a "carried interest"—a key element of the so-called "2 and 20" incentive structure often used by hedge and venture capital funds.

Does such legislation pose a major threat to commercial real estate? I believe that it does, and so do two leading real estate groups — the International Council of Shopping Centers (ICSC) and the Real Estate Roundtable — who have been vocal on this issue. On July 31, 2007, before the Senate Finance Committee, a spokesman of these groups stated that the proposed legislation is reminiscent of the 1986 Act; and that "no one foresaw that (the 1986 Act)... would have contributed to the Savings and Loan collapse, the formation of the Resolution Trust Corporation and a credit crunch that caused a major downturn in the real estate industry". A bill on this subject is also being drafted by Senator Charles Schumer of New York.

Upon reading that testimony, I looked at the Internal Revenue Code, and discovered that the term "carried interest" is not defined or found in the code. Perplexed, I searched the internet, and found the Glossary of Private Equity and Venture Capital defining carried interest as:

"The portion of any gains realized by the fund to which the fund managers are entitled, generally without having to contribute capital to the fund. Carried interest payments are customary in the venture capital industry, in order to create a significant economic incentive for venture capital fund managers to achieve capital gains."

While the enormous returns being realized by venture capital funds, private equity funds or hedge funds seem to be the intended targets, real estate will be disproportionately impacted by this legislative initiative. If this legislation is aimed at fund managers in the venture capital industry, why is the commercial real estate industry so concerned about it? Simply put, fund managers act in many ways like general partners in real estate partnerships, and 46 percent of partnership tax returns come from the real estate industry, and the proposed legislation does not distinguish between the two industries.

In the venture capital industry the so-called "2 and 20" incentive structure works this way. The general manager of a venture capital fund (also known as a private equity fund or hedge fund) is generally compensated in two ways: 1) a management fee for services rendered which is often equal to 2 percent of capital committed by passive investors, which is taxed at ordinary income rates and 2) a "carried interest" which is typically 20 percent of the venture's profits, as to which taxation is deferred until profit is realized on the venture's assets and is then taxed at capital gains rates, when realized.

From a technical standpoint, the carried interest is not taxed at the outset because the value is too uncertain given the risks described below, but is only taxed when profit is allocated to the carried interest following a realization event, receiving the same tax treatment as other profit distributed to partners — primarily capital gains.

The concept of a carried interest is not new. A prominent English venture capitalist reminded me: "Carried interest has been around for centuries when ships' captains took 20 percent of the cargo they brought back".

Fund mangers and general partners both receive income that is treated as ordinary income for tax purposes — in the case of real estate, they are compensated for coordinating the development process of design, development, leasing, financing and sale. However, general partners also perform an even more important role — taking risk to create capital value.

Let's look at these risks. They can include risk for all partnership liabilities such as environmental claims, lawsuits, guaranties of loans, such as guaranties of construction completion, removal of construction liens, leasing operating deficits and debt. But there is even more risk. The general partner typically doesn't receive any of its capital gains until investors first receive a "preferred return" on their investment at a specified percentage, say 8 percent or 9 percent. Next, the investors receive a full return of their invested capital and a predetermined share of the enterprise's profits. Finally, at this point, the general partner receives its "sweat (and risk) equity" — a fixed percentage of residual, contingent income, which is typically taxed at capital gains rates — the same rates paid by the other partners.

Proponents of the Levin bill oversimplify by saying that all income of all general partners, whether in the form of management fees or carried interests, should be taxed at ordinary income tax rates — more than doubling the current rate on carried interest. Such proponents ignore the inconvenient truth that general managers who manage real estate development projects do much more than just run the business, for which their income is already taxed at ordinary income rates. They ignore the fact that such general partners are the catalyst for undertaking risky real estate ventures, and more importantly, absorb much of that risk personally. Bankruptcy caused by real estate failure is common in this cyclical industry. Without the general partner's initiative and willingness to take real risks, limited partners, whose liability is generally limited to the capital that they provide, would either 1) significantly increase their risk exposure, and demand a much higher return—making risky but crucially important deals, such as new projects in inner cities, financially infeasible; or 2) they would simply reallocate their capital to another, safer, use. Taking away the carried interest's favorable tax treatment from the general partner, earned

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by taking risk, would adversely affect new development at a time when our country desperately needs strong growth in GDP and employment.

While the impacts of the proposed Levin bill are quite serious as applied to the general partner of a real estate partnership, the bill also subjects the capital gains of certain "inside" limited partners' (i.e. limited partners who are involved in the business operation) to ordinary income tax treatment at a 35 percent (or 39.6% or higher depending on election outcomes). This is particularly clear where the ratio of invested capital to profits by inside limited partners is significantly greater than the same ratio for the outside investors.

The Levin bill would tax all "Investment Services Partnership Interests" as ordinary income. Such interests include any ownership by persons who conduct a "substantial quantity" of any of several services to a partnership ranging from involvement in acquisition and disposition, asset valuation, management, financing or anything supporting such activities.

I have seen first hand the devastating impact that ill-conceived legislation with unforeseen consequences can have on the health of our economy. From 1990 to 1993, I served as President of the Oversight Board of the Resolution Trust Corporation. In that capacity, I observed the devastation of the real estate market, and President H.W. Bush's reelection chances. These results were the unintended consequences of the risk-based capital standards targeting commercial real estate (from the 1989 act known as FIRREAH); and the 1986 Act described above. At one point this debacle produced a $400 billion RTC inventory, much of which comprised commercial debt and real estate, which had to be returned to a private sector that had been regulated into avoiding such assets — resulting in losses to our country far exceeding $100 billion.

Here again, we have legislation that will produce unintended consequences for real estate development. The bills are aimed at private equity and hedge funds where huge profits are made without the high personal financial risks associated with developing commercial real estate. In real estate ventures, the extreme personal financial risk justifies the carried interest.

Therefore, the best solution is to demonstrate to Congress that general partners, whether in the venture capital or real estate industry, perform the key functions of spearheading entrepreneurial enterprise and development. In particular, real estate development involves the assumption of great risk by the general partners. It is specious to compare the tax rate paid by hourly or salaried employees to the capital gains of a general partner who has assumed significant personal financial risks. Congress must be made to understand that risk-taking is the basis for economic growth. Currently, our country is facing heavy competition in many markets where risk-taking is rewarded. U.S. creativity and risk-taking must be rewarded in the same manner. At a minimum, it is imperative to exempt real estate partnerships from legislation aimed at curbing the purported abuses of the hedge, private equity and venture capital industries.

Peter Monroe, who recently founded Wilherst Realty in Florida, has served three presidents, run two federal agencies and ran last year for the U.S. Senate from Florida. He has been engaged in development and brokerage for more than 35 years. He is a graduate of Williams College, Oxford University and Harvard Law School.

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