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## Show Me the Money

### A House Bill Would Force Investment & Hedge Fund Managers to Pay More Taxes

By Amanda Marsh

Commercial real estate executives are up in arms over a U.S. House of Representatives bill that, if passed, could dramatically impact the tax rate that private equity fund managers and hedge funds are held to.

House of Representatives Committee on Ways and Means chairman Charles Rangel has put forth the Tax Reduction and Reform Act of 2007. The landmark legislation seeks to amend the Internal Revenue Code of 1986, reducing taxes on working families and reforming tax laws to eliminate both loopholes and narrowly targeted benefits, according to a release. A committee spokesperson said hearings will not take place until 2008.

The bill would introduce tax relief through a permanent repeal of the individual alternative minimum tax. To fund the change, though, the proposed legislation provides other reforms, including the taxation as ordinary income of car-

ried interest, the interest a fund manager receives from an investment's profit.

Both the real estate and broader private equity industries widely employ the carried-interest model, and Congress views the reallocation of capital gains to ordi-

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nary income, which would more than double the existing tax rate on that money, as an opportunity to raise significant revenue, noted an Ernst & Young L.L.P. report that was released in September.

If passed, the proposal—expected to raise \$26 billion over 10 years—will affect private equity funds more than it will impact hedge funds. And it also stands to be the most heavily lobbied-against effort to affect commercial real estate, noted David Reiner, managing director of capital for Grosvenor Investment Management. "Everyone has hired the heaviest hitter to kill the bill and views it as a serious threat."

Under Section 1201 of the proposed legislation, investment fund managers would no longer pay taxes at capital gains rates, currently 15 percent, on investment-management-service income that is received into an investment fund as carried interest. Instead, such managers would be required to treat it as ordinary income, currently taxable at 35 percent.

A manager of a \$1 million fund, for instance, might receive 20 percent of

any profit as payment. If that manager, on behalf of his investors, buys a building for \$1 million and sells it for \$1.5 million, he would receive a return of \$100,000—20 percent of the seller's \$500,000 profit—which, as a gain of sale, would be taxed as a long-term capital gain, explained Eric Woldenberg, a partner in law firm Pryor Cashman L.L.P. Under the current regulations, the manager would be taxed \$15,000, a figure that would increase to \$35,000 if the proposed changes go into effect.

The Ways and Means committee stated that the character of the income should reflect the character of the



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commodity purchased, explained Evan Migdail, a partner in law firm DLA Piper's corporate, tax and regulatory practice. In this case, the manager is being paid for his services, which some legislators believe should be taxed as ordinary income.

Especially since The Blackstone Group L.P.'s shopping spree of 2006 and 2007, which included February's \$39 billion acquisition of Equity Office Properties Trust, the public has become more aware that fund managers' carried interest is taxed as long-term capital gains, Reiner noted. Some believe that general managers receive disproportionate shares in a limited-partnership fund because they take greater risk than the limited partners. "But they're taking risk with other people's money, not necessarily their own, so are they really taking risk?" Reiner asked. "That's the fundamental question: Whose money is being risked?"

Because the carried-interest model serves as an incentive for the fund manager to perform well, these proposals, if passed, may hinder investment funds' ability to attract the best and brightest talent. "These proposals are a threat," Reiner added. "(The funds) are already competing with the investment banks, and now compensation may be sliced."

And the real estate fund sector has grown significantly, fueling the recruitment competition. "The connection between outstanding fund performance and a deeply talented and highly motivated management team is hard to refute," according to the Ernst & Young report.

However, fund managers may find another way to make investment managers' compensation look like something other than ordinary income: for instance, purchasing interest for a partial non-recourse note, which allows a recourse of a certain percentage should the interest purchased become worthless. Managers therefore would not carry interest and thus that income would still be capital gains. "Rather than being purely incentivized, they'll simply be shoulder to shoulder with everyone else yet still get their (interest)," stated Harold Levine, partner & chair of law firm Herrick, Feinstein L.L.P.'s tax department. "If everyone is playing the same game, it won't matter. ... People will become more creative, and many have discussed how to do this already."

Private equity funds have remained quiet about the effects of the proposed legislation, and many leading executives declined to comment when asked how the bill would affect them.

The provision seems to have much stronger support from Democrats than from Republicans, though it is not a straight-ticket issue, Levine said. Overall, industry players are uncertain whether the legislation will pass, and debate could last another nine or 10 months, Migdail noted. As of late November, the Senate did not have companion legislation.

But whenever Congress changes taxation ground rules, it historically has failed to foresee the consequences, noted Adrian Zuckerman, co-head of Epstein Becker & Green P.C.'s national real estate group. In 1988, for instance, passive investment tax laws triggered a recession. "No one foresaw the dire consequences on (savings & loan associations) in 1988. That was a big downturn and eliminated a lot of investment vehicles," he said. "Whatever we do politically comes back and may have repercussions on other sectors."

### **Trim the Hedges**

Tax changes could affect hedge funds, as well. Section 1202 of the Tax Reduction and Reform Act of 2007 would prevent hedge fund managers from using offshore-tax-haven corporations and other structures to defer taxes on com-

penetration received for investment services. The legislation would require managers to take this deferred compensation into account as it accrues, according to a Ways and Means committee release. The bill projects that Section 1202 would raise \$23 billion over 10 years.

Hedge funds that have gone public may also feel a sting from the so-called "Blackstone Bill" proposed by senators Max Baucus and Charles Grassley two months after The Blackstone Group's March IPO. The bill wants to tax such entities not as publicly traded partnerships, which enjoy the 15 percent capital gains rate, but as a corporation at the ordinary income rate of 35 percent. Those that went public before the introduction of the bill, such as Blackstone and Fortress Investment Group L.L.C., would be grandfathered for another five years before having to comply.

The bill, which Levine reported has gone through a few different incarnations, may deter hedge funds from going public if passed. But even so, only a few non-grandfathered entities would be immediately impacted.

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