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Post-Election Debates

How Will Congress's Shift in Balance Impact Critical Real Estate Concerns?

By Allison Landa

Fall can bring change, especially when there is a midterm election in the offing. This year, not surprisingly, came a substantial shift in the U.S. Congressional makeup, with the Republicans winning an additional 60 seats in the House of Representatives, though the Democrats clung to their majority in the Senate. This switch in the power balance provides a tumultuous backdrop for some of the major issues currently facing real estate.

"The lame duck's going to be a mess," Urban Land Institute senior resident fellow John McIlwain proclaimed. "What they get to do and how they handle it is really going to be interesting to watch. It's going to be kind of ugly, but we'll see what comes out."

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One of the most hotly contended issues, carried interest, is on the lips of prognosticators and pundits throughout the nation. McIlwain predicted that since the House has grown more conservative, carried interest provisions will be addressed to the likings of business interests.

Or, he said, there could be a populist backlash.

"The importance is really to fairly wealthy people, and it's a tax break to fairly wealthy people," he said. "It's going to be interesting to see how the populist fervor of the Tea Party people plays out in the Republican caucus when it comes to tax issues."

Those tax issues include the expiring Bush tax cuts—whether cuts will be extended for all, extended for those making $250,000 or more annually or allowed to expire for all.

Betsy Laird, a senior vice president in the International Council of Shopping Centers' office of global public policy, said her organization will support the extension of the Bush tax cuts and business tax extenders, including the 15-year leasehold depreciation, brownfields expensing and Build America Bonds that carry special tax credits and federal subsidies for either the issuer or the bondholder—as long as carried interest is not included as a pay-for.

"It is our hope that Congress will move the tax extenders legislation, which will help provide temporary incentives to create jobs and investment in the economy," she said. "However, more important, Congress should remain steadfast in its opposition to try to offset the extenders bill with a permanent, poorly conceived carried interest tax increase that lands squarely on the back of commercial real estate."

Ken Fields, a partner in Los Angeles-based business law firm Silver & Freedman, also believes there will be a major push for the tax extenders legislation. He added that he believes the two largest issues facing real estate are the future of the CMBS market and financial world in general as well as the future of Fannie Mae and Freddie Mac.

He predicted that Republicans will go after the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Obama administration's swing at financial reform.

"My own impression with the takeover in the House," he said, "is that we're going to see more nibbling at the edges of Dodd-Frank, as opposed to any material changes."

McIlwain is more sanguine, particularly when it comes to Fannie and Freddie's future. He predicted a lot of talk but not much action, at least for the time being. He argued that eliminating or toying with the government-sponsored enterprises could result in driving down the already-low rate of housing production, eliminating more jobs and pushing back into the recession's second dip.

Instead, he advocates waiting to see if a longer-run consensus can be developed.

"The Republicans have said that they are committed to abolishing Fannie and Freddie, and the fact of the matter is that nothing is going to happen," he said. "There'll be hearings in the Senate; there may even be legislation to get through the House on Fannie and Freddie. But it won't get through the Senate and it won't get past the President. More than likely, there will be a bunch of bills floating around, but not much will happen in the next two years—which is probably the right answer anyway. Until the market has come back to some degree of vibrancy, it just makes no sense to tinker with Fannie or Freddie."

McIlwain's colleague, Urban Land Institute senior resident fellow Stephen Blank, sees job creation and its impact on real estate fundamentals as the industry's most serious issue. Calling it "the tail that wags the dog," he asserted that the economy first needs to start to grow and jobs must be created.

Until that time, he said, it would be illogical for people to take space in office and retail properties or to rent new apartments.

"Commercially," he said, "it's jobs, jobs, jobs."

However, Blank added, given the radical change in the legislative atmosphere, predictions are just that—predictions. He voiced the hope that the warring sides will find some means of cooperation.

"One would hope that they will find a way in Washington to somehow work together to perfect some solutions and start to put some pressure on solving problems," he said. "I hope whatever it is, it doesn't deteriorate into, 'It's my way or the highway.' "

Ed Indvik, a managing director in commercial real estate services firm Lee & Associates' investment services group, said the legislature is on the hook to put tools into businesses' hands so that they feel at liberty to invest in human as well as physical capital.

"If that does manifest itself, then that's good for real estate simply because our occupancy is driven as a direct result of employment," he said, "and so to the extent that we have businesses that are willing to expand and occupy more space, that's going to augment the demand side of real estate, which will then firm up prices."

Blank said that the legislature is facing a collective disease on the part of the U.S. population.

"People are clearly and deservedly nervous about the amount of debt the country has," he said. "People are clearly concerned about the amount of money that we're spending on any number of programs, from defense to social entitlement. And they well should be."

And then there is QE2, or quantitative easing in order to fend off deflation. McIlwain sees it as more of a defensive move to keep interest rates from going up than an initiative that will spur demand. Also, he noted, there is the potential for a backlash from flooding the markets with more dollars, which in turn could make the international currency markets nervous, thereby dropping the value of the dollar.

That, he believes, could spur holders of international Treasuries to start moving their money to other currencies, offsetting the benefit of the Fed's move.

"(QE2) will probably bring down single-family mortgage rates modestly, although they're already so low that one wonders why that will have much impact on the single-family market," he said. "Multi-family will be helped a little bit, but again, rates are so low, it's not really what's necessary to increase starts in the single- and multi-family market—and that's really driven more by employment, people wanting to spend rather than save."

He added that there is not likely to be a QE3 due to the rotation of the Fed board. "The new members are much more conservative than the existing ones," he noted. CPE

Pre-eminent Issue: Carried Interest

Many industry players consider carried interest the pre-eminent issue for real estate. Betsy Laird, a senior vice president for the International Council of Shopping Centers' office of global public policy, said the organization's main focus will be fighting against what she called "the most sweeping and potentially most disruptive new tax on commercial real estate partnerships since the Tax Reform Act of 1986."

Laird argued that the tax increase will impact all real estate partnerships, past and future, large and small. She believes that it is anti-investment and will threaten economic development projects and related jobs, hitting small and medium-size developers hardest.

"The real estate community has been working hard to point out the major flaws and unintended consequences of this legislation, such as significant new taxes on family partnerships and enterprise value," she said. "It is our hope that Congress will extend the important tax incentive legislation without including the carried-interest revenue-raiser. Certainly, the revenue raised by the less-than-fully-vetted carried-interest tax proposal is a drop in the bucket compared to what Congress would need to pay for the major tax legislation up for consideration in the lame-duck session."

Integra Realty Resources president & COO Jeffrey Rogers also sees carried interest as the most pressing issue facing real estate. Like Laird, he strongly opposes the proposal, saying that it would have a disastrous impact not only on commercial real estate but businesses in general, since Americans use partnerships to hold real estate and various business interests.

He added that partnerships could see their taxes increase by 150 percent or more.

"Essentially, the change in tax would make it very difficult for entrepreneurs without unlimited capital to build a sustainable enterprise, thereby stifling entrepreneurship, economic growth, and most important, job creation," Rogers said. "A tax of this magnitude could not come at a worse time."

But Ed Indvik, a managing director in commercial real estate services firm Lee & Associates' investment services group, disagrees.

"I probably am in the camp of those who say it should be taxed as income as opposed to capital gains," he said. "I know that's unpopular for many of those who act as general partners in those funds. ... I look at it as earned income, and as such, from a theoretical standpoint, I have a hard time arguing that it shouldn't be taxed as ordinary income."

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