OPINION

REVIEW & OUTLOOK

Crashing Real Estate

Ronald Reagan liked to describe the sequence of actions that government typically takes toward private business: "If it moves, tax it. If it keeps moving, regulate it. If it stops moving, subsidize it." Our government is now doing all three at the same time to America's real-estate market, and with the brilliant results you'd expect.

Is this really the time for a tax increase on commercial property?

It's the taxing part that represents the most immediate threat to the commercial market. Despite price declines of more than 30% in many areas since the height of the boom, commercial real estate has not become the default moonscape observed in the residential market.

At least not yet. But a plan passed by the House and pending in the Senate would raise "carried interest" taxes on the managers of many real-estate partnerships from the current capital gains tax rate of 15% to the top income tax rate, scheduled to hit 39.6% on January 1. Carried interest is the gain these managers receive if the assets held by the partnerships rise in value.

The limited Congressional debate thus far has focused on the negative impact of this tax increase on private equity and venture capital. And the tax hike will surely reduce the incentive to invest in job-creating technology companies, among other destructive effects. But as many as half of the investments targeted by this tax would involve commercial real estate, according to the Commercial Real Estate Development Association. Senate Finance Chairman Max Baucus is negotiating a complicated timetable for phasing in the tax hike, but the end result is clear: less incentive to invest.

This Beltway assault on the real-estate market is remarkable, given that Washington is simultaneously spending billions of dollars to resuscitate it. Taxpayers can't possibly keep track of all the mortgage aid programs that began with George W. Bush's Hope Now Alliance and continue with Barack Obama's Home Affordable Modification Program, the home-buyer's tax credit and the special foreclosure mitigation operations of Fannie Mae and Freddie Mac.

As for regulating, the thousands of pages of financial-reform bills passed by the House and Senate will impose new rules on the entire financial chain from mortgage origination to servicing to securitization to investment (except of course if your name is Fannie or Freddie).

But it is the tax increase on real-estate partnerships, which own most of the commercial buildings in many U.S. markets, that could have the most immediate impact. By reducing the after-tax gain that a potential manager could expect to realize, the tax increase would put downward pressure on prices in a market struggling to recover.

According to this week's Federal Reserve "beige book" report on economic conditions, "Commercial real estate activity generally remained weak." The report added that "the elevated inventory of existing properties for sale or rent continued to weigh on new private nonresidential construction."

Naturally, Senate Majority Leader Harry Reid thinks it's about time to vote on a tax increase for the creators of such projects. He may get away with it, in part because so many in the industry are too busy trying to survive right now to worry about a rate increase. "There are no profits to tax," says New Jersey developer William Procida.

But valuations are key to avoid a replay of the residential debacle in commercial property. Over the next five years, more than $1.5 trillion in commercial real-estate debt will be falling due. Without the subsidies poured into the residential market, many managers of commercial properties have aggressively responded to the downturn by raising capital, or by buying back or restructuring their debt. Now Washington arrives to impose a new burden.

Congress and the White House have tried everything under the sun to put a floor under the housing market, but for the commercial side they seem eager to knock out the foundations. Per President Reagan's advice, could the politicians at least wait until a business is moving to start increasing taxes on it?