Trend Report: Issues Our Clients Are Talking About

The Current Status of the "Carried Interest" Debate and Proposed Legislation

There is a great deal of debate and concern over the proposed “Carried Interest” tax legislation. Carried Interest is loosely defined as the share of profits that promoters or organizers of funds (including real estate funds) receive in connection with a fund that they put together. In general, a Carried Interest is not related to a return on cash or property contributions made to the fund, but is usually viewed by many as compensation to the organizer for putting the fund together and managing its activities.

Currently, income received in connection with a Carried Interest in a real estate fund is usually treated as taxable gain that is subject to capital gain rates (which are currently imposed at a tax rate of 15%). Under the newly proposed legislation (which was recently passed by the House of Representatives), income earned on Carried Interest in a real estate fund will be taxed not only at capital gain rates, but also at ordinary income rates (which are currently imposed at a top marginal rate of 35%). Specifically, beginning on January 1, 2011, 50% of the income earned on Carried Interest will be taxed at capital gain rates and 50% will be taxed at ordinary income rates. Under this proposed legislation, the Carried Interest tax allocation will be adjusted again effective January 1, 2013, such that 25% of the income earned on Carried Interest will be taxed at capital gain rates and 75% will be taxed at the higher ordinary income rates. If adopted, these newly proposed tax rules would apply to all Carried Interest earned on or after January 1, 2011, regardless of when the applicable fund was initially created.

The Senate intends to take up the bill later this month.

There has been great concern expressed in the real estate community about this legislation, because it appears to require future change in longstanding patterns of real estate investment structures and development. For existing real estate funds, this legislation could be even more problematic. Many lobbying groups are currently weighing in, and asking their members to write to Congress in an effort to prevent the passage of the proposed new law.

City of Chicago Not Required to Follow its Own Procedures

A recent decision by the Illinois Appellate Court (First District) affirmed that, in addition to making laws, the city council or board of trustees of an Illinois home rule municipality has the right to not follow them (as long as no State or Federal constitutional or statutory protections are violated). *Condominium Association of Commonwealth Plaza, et. al.* (*collectively, the “Association”*) *v. City of Chicago* (*“City”*); *Resurrection Health Care and Saint Joseph Hospital* (*collectively, the “Hospital”*), *et. al.*, (*Docket Nos. 06 CH 12361 and 22757*); *opinion filed March 5, 2010*.

In 2006, the Chicago City Council adopted an ordinance approving planned development zoning for the Hospital’s lakefront campus property, allowing construction of an office building and other improvements. Among other objections, the Association opposed development of the office building, apparently in connection with the building’s proximity to the Association’s condominium high-rise building; the Association sued the City and the Hospital. One Association claim stated that the planned development ordinance (the “planned development”) violated the Chicago Zoning Ordinance (the “Zoning Ordinance”) by allowing the density of the project contemplated by the Hospital to exceed that allowed under the pre-existing zoning classification. Another claim stated that the planned development did not adequately provide a schedule for developing the various phases of the project, as required by the Zoning Ordinance.

The trial court agreed that the planned development was in violation of the Zoning Ordinance in these respects (and others not discussed here), and declared the entire planned development void. [Editorial note: the trial court’s conclusion that these provisions of the Zoning Ordinance, as applied to the planned development, result in violation of the Zoning Ordinance is not, in our view, as clear-cut as the trial court would have it.] The trial court subsequently agreed, however, to reconsider its decision based on the alternate ground that, whether or not procedural violations or inconsistencies occurred, the City Council is not required to follow its own procedures. The trial court agreed,

stating that "…lack of compliance did not support an order invalidating the [planned development]…solely on account of its purported non-compliance with the Chicago Zoning Ordinance." (Neither the trial court nor the Appellate Court disturbed the trial court's finding that the planned development was enacted in violation of the Zoning Ordinance.)

On appeal, the Appellate Court cited a 1988 Illinois Supreme Court decision, *Landmarks Preservation Council of Illinois v. City of Chicago*, *125 Ill 2d 164* (*the "Landmarks" case*) as the controlling precedent. In the *Landmarks* case, the City designated the facades of the old McCarthy Building as a historic landmark in 1984; precluding the building's demolition. The building was located on the site known as Block 37. Later, in connection with its efforts to revitalize the surrounding North Loop area, the City determined that the existence of the McCarthy Building constrained the design and development of the Block 37 project. In 1987, the City Council rescinded the historic designation, thus allowing the entire McCarthy Building to be demolished. The Supreme Court stated that that home rule units have broad legislative powers; "the same powers as the sovereign except where such powers are limited by the General Assembly." The Court further found that a statement made in another Appellate Court case (*Chirikos v. Yellow Cab Co.*, 87 Ill App 3d 569 (1980)) aptly summarized its findings as applied to the *Landmarks* case: "This court cannot handle matters which in effect are attempts to overrule decisions of a legislative body based upon the alleged failure to follow requirements imposed by that body itself…We have the authority to invalidate legislation adopted by the city council only upon grounds that the enactment violates a provision of the Federal or State constitutions or violates the mandate of a State or Federal statute."

Applying the reasoning and precedent of the *Landmarks* case, the Appellate Court agreed with the trial court's conclusion in favor of the City and the Hospital.

Tenants Should Reconsider Limitation of Landlord Liability Clause

The new economic realities of the recession have dramatically altered basic assumptions underlying commercial lease transactions. Foreclosures, bankruptcies and "zombie" buildings are now realities that necessitate new ideas and creative clauses. Another area that should be reconsidered by every tenant is the limitation of the landlord liability clause. This clause generally limits a landlord's liability to the landlord's equity interest in the property. It has become a generally accepted clause in commercial leases under the theory that a landlord cannot be expected to place all of its assets at risk to hundreds of tenants across its portfolio. The theory also assumes that such limitation will leave tenants with sufficient assets to claim or collect upon in the event of litigation. In today's economic climate, however, where it is not an exaggeration to say that perhaps 80-90% of major commercial properties are "underwater" and carry mortgages that exceed the value of the property, this traditional limitation has evolved into a de-facto complete waiver of claims against the landlord. Accordingly, tenants must begin to reexamine the customary acceptance of this clause, and do their due diligence to determine whether a landlord has any equity remaining in the property.

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