The Real Estate Roundtable

May 29, 2013

The Honorable Patrick Tiberi
Chairman
Subcommittee on Select Revenue Measures
House Committee on Ways and Means
1136 Longworth House Office Building
Washington, DC 20515

The Honorable Richard Neal
Ranking Member
Subcommittee on Select Revenue Measures
House Committee on Ways and Means
2208 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Tiberi and Ranking Member Neal:

Thank you for the opportunity to submit written comments in relation to your May 15, 2013 hearing on the Ways and Means Committee's small business and pass-through entity tax reform discussion draft.

The Real Estate Roundtable brings together leaders of the nation's top publicly-held and privately-owned real estate ownership, development, lending and management firms and leaders of major national real estate trade associations. Collectively, Roundtable members' portfolios contain over 5 billion square feet of office, retail and industrial properties valued at more than $1 trillion; over 1.5 million apartment units; and in excess of 1.3 million hotel rooms. Participating trade associations represent more than 1.5 million people involved in virtually every aspect of the real estate business. The real estate industry accounts for nearly 1/4 of taxes collected at all levels of government.

Federal tax laws need to be revamped to unleash entrepreneurship, investment, and job creation. Well-designed tax reform will remove unnecessary complexity, create a level playing field, and ensure transactions are motivated by legitimate business purposes. Poorly conceived tax reform, or tax reform that unduly increases the overall tax burden, however, could depress capital investment and undermine the economic recovery.

Congress must carefully study and consider how changes to entity classification rules or the tax treatment of pass-through businesses will affect real estate and other sectors that rely on the use of pass-through entities to mobilize capital for new, job-creating ventures. Shifting large pass-through firms into an entity-level tax regime would alter the underlying economics of real estate investment and transactions to the detriment of new projects and economic growth.

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The U.S. commercial real estate sector uses the full range of organizational forms available under the tax code to develop, finance, and manage income-producing projects, including: partnerships, limited liability companies (LLCs), S corporations, C corporations, and real estate investment trusts (REITs). The availability of these different forms of organization serves the capital, ownership, and operational needs of diverse real estate projects and endeavors. Nearly half of the 3.2 million partnerships in the country are real estate partnerships. Current pass-through entity classification rules contribute to the dynamic nature of the U.S. commercial real estate market, and The Roundtable supports preserving the elective pass-through structure regardless of the size of the business.

The small business and pass-through discussion draft proposes a menu of potential tax policy changes. Option 1 seeks to modernize current tax rules affecting S corporations and partnerships. Option 2 seeks to overhaul the taxation of pass-through entities by repealing existing tax rules governing partnerships and S corporations and replacing those rules with a new unified pass-through regime.

Option 1: Revisions to current pass-through tax rules

Option 1 includes several well-designed reforms to simplify and improve current Subchapter K and Subchapter S of the Internal Revenue Code. For example, the discussion draft's proposal to repeal existing rules related to guaranteed payments to partners would simplify tax reporting for partners and partnerships and reduce the tax gap by improving compliance through employer withholding. The provision in Option 1 to repeal the special rule governing payments to retiring and deceased partners would update an area of partnership taxation to better reflect underlying changes in the tax law.

A proposal in Option 1 to repeal the 7-year limitation and perpetually apply the so-called "anti-mixing bowl rules" in sections 704(c)(1)(B) and 737, however, would unnecessarily increase administrative burdens on real estate partnerships, artificially distort business decisions, and effectively discourage job-creating economic activity. Anti-mixing bowl rules are an appropriate means of preventing tax avoidance through disguised sales. But requiring partnerships to indefinitely trace property and the contributed gain would further complicate an area of partnership tax already prone to error. Taxpayers frequently unwind partnerships for legitimate, non-tax business reasons, and this proposal would impede the efficient allocation of resources to new and more productive investments.

Option 2: Unified rules for pass-through business entities

Option 2 proposes replacing the current rules with a new, unified pass-through regime. Despite its conceptual appeal, The Roundtable is concerned that the unified pass-through regime in Option 2, as currently drafted, would adversely affect commercial real estate development and growth. A unified pass-through regime that promotes entrepreneurship, investment, and job creation would require significant changes that take into account the flexibility and other benefits inherent in Subchapter K of the tax code. A few of The Roundtable's specific concerns with Option 2 include the following:

- **Curtailing the ability of partnerships to specially allocate items between partners would disrupt common real estate arrangements**. Disproportionate distributions are normal in capital-intensive partnerships and arise from the disparate ways in which partners contribute to the success of a real estate enterprise—*e.g.*, management or operational skill, capital contributions, guaranty of construction loans, or some combination of these factors. The timing of capital contributions can also influence distribution priorities among partners, especially in distressed businesses. Special allocations help real estate partnerships bring varied parties together to participate in risk-based investments. By limiting special allocations in three broad categories--ordinary items, capital gains, and tax credits--Option 2 would impede future, job-creating commercial real estate development.[1]

- **Requiring partners to recognize gain on distributions of appreciated property would result in the taxation of noneconomic gains and make it difficult to exit from real estate partnerships**. The proposal would complicate, and in some cases prevent, normal partnership restructuring transactions, including mergers, acquisitions, and reorganizations. As a consequence, the proposal would likely discourage capital formation and investment in commercial real estate ventures by altering potential investors' analysis of the risks and commitment involved in new ventures.[2]

- **Imposing a new, mandatory withholding regime on the distributive share of pass-through income would require complex rules and create unnecessary administrative burdens**. Unlike salary arrangements between employers and employees, partnership income is highly volatile and unpredictable. A tax withholding regime for pass-through income would require a complicated set of rules to address income fluctuations within a given taxable year. Special rules would be necessary for tax-exempt partners and other partners with deductions that offset partnership income. Even with exemptions, a mandatory withholding regime would inevitably result in over-withholding for many taxpayers, thus withdrawing scarce capital from private investment uses. Taxpayer compliance costs associated with a withholding regime would likely exceed the benefits to the U.S. Treasury.[3]

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[1] The three category approach does not simplify the administration of pass-through entities or "level the playing field." Instead, the opposite effect may occur and lead to a new set of controversies over arrangements designed to circumvent the rules.

[2] Most small business corporations taxed as C corporations rarely distribute appreciated property unless the distribution is part of a tax-free reorganization. It is unlikely making all distributions from partnerships taxable would raise revenue. Such a provision would drive real estate "partners" to more co-ownership arrangements. Such arrangements may eliminate special allocations and Subchapter K complexity, but would increase the cost and complexity of tax administration. Co-ownerships would also complicate real estate financing and could hamper economic activity.

[3] A number of States impose mandatory withholding on nonresident partners' distributive shares of income. These rules are inconsistent and complex. Difficulties arise when income is earned unevenly throughout the tax year and where partners have different economic sharing arrangements. For example, withholding may vary quarter to quarter where net income allocations are based on a "waterfall" that represents varying capital priorities among the partners.

Additional reforms to simplify, streamline, and improve the tax system for partnerships and pass-through business entities

The Roundtable supports alternative steps that could be taken to address the complexity, uncertainty, and inadvertent mistakes that arise under current partnership and related rules. For example, Congress should consolidate rules that limit or defer the use of partnership losses. Second, Congress should repeal and replace the overly-mechanical provisions governing the allocation of income between taxable and tax-exempt partners in leveraged real estate partnerships.

Reduce uncertainty and complexity by consolidating partnership loss limitation regimes. Congress should simplify and consolidate the four separate statutory regimes aimed at limiting or deferring a partner's ability to deduct partnership losses: (1) at-risk rules under section 465; (2) allocation rules under section 704(b) and (c); (3) limitation on deductible losses to outside basis under section 704(d) and 752; and (4) passive activity loss rules under section 469, all of which are very important to real estate investment. The first three regimes seek to limit deductible losses to the taxpayer's investment exposure to the business, including some measure of the taxpayer's share of borrowed capital. Each regime, however, has rules that are materially different from the others and often conflict with one another.

The interaction of these loss-limitation regimes leads to unnecessary complexity, business uncertainty, and misapplication of the rules by taxpayers and the IRS. For example, the same nonrecourse debt that allows a partnership to allocate a loss to a partner and increases the partner's outside basis does not necessarily increase the partner's at-risk amount because the at-risk rules impose a unique set of requirements on *qualified nonrecourse financing*. Such non-intuitive distinctions frequently confuse tax practitioners and revenue agents.

Uncertainty and unnecessary taxpayer mistakes could be avoided by repealing at-risk rules and modestly harmonizing the allocation and basis rules. The purpose of the at-risk provisions is adequately served by the allocation and basis loss limitation rules. Additionally, Congress should clarify that distributions in excess of a partner's basis (section 731) and deemed distributions (section 752(b)) are measured only at year-end after all allocations, including any special allocations. Such a clarification supports the annual accounting concept.

Remove barriers to investment in U.S. commercial real estate by replacing the "Fractions Rule" and expanding the debt-financed real property exception. Tax-exempt investors can generate passive income without tax from sources such as dividends, interest, rent, and gains from the sale of property. Such income is generally taxable, however, if it is debt-financed. An exception to the debt-financing rule applies to pension funds and educational institutions that own real property. In addition, if certain requirements are met, pension funds and educational institutions can earn nontaxable income from debt-financed, real property held by a partnership that includes a taxable partner, such as a real estate company. In real estate partnerships, the so-called Fractions Rule, section 514(c)(9)(E), is intended to prevent the abusive allocation of taxable income to tax-exempt partners. The Fractions Rule strictly requires that the exempt organization's share of partnership income in any year is not greater than the smallest share of loss allocated to it.

The Fractions Rule, as currently written, prevents pension funds, educational endowments, and other tax-exempt investors from efficiently diversifying their investment base and deploying much-needed capital into job-creating real estate ventures. The Fractions Rule should be repealed and replaced with a more flexible rule that requires the partnership allocations to have substantial economic effect. This will prevent tax avoidance yet allow the partnership to allocate income and loss that reflects the economic relationship of the partners.

Also, currently, even the slightest violation of the Fraction Rule's statutory requirements generally taints the entire investment and converts to unrelated business taxable income all debt-financed income earned by all tax-exempt partners from the investment. This cliff effect for even a minor, non-abusive infraction of the allocation requirements is unduly harsh and should be replaced with a penalty more proportional with the violation.

More broadly, Congress should expand the debt-financed real property exception to cover other types of tax-exempt investors, such as private foundations and public charities. Extending the exception to other tax-exempt organizations would remove an artificial barrier to new investment in U.S. commercial real estate.

Lastly, while The Roundtable welcomes a simpler, more rational tax code, we strongly urge that Congress undertake comprehensive tax restructuring with caution, given the potential for tremendous economic dislocation. The Tax Reform Act of 1986, for example, ushered in a series of overreaching and over-reactive policies—in some cases, such as the passive loss limitations, on a retroactive basis and applicable to preexisting investments. The changes had a destabilizing effect on commercial real estate values, financial institutions, and Federal, state and local tax bases. Any changes, therefore, must provide for a reasonable multi-year transition regime that minimizes dislocation in, and disintermediation from, real estate markets.

Thank you again for the opportunity to present The Roundtable's perspective on the small business and pass-through tax reform discussion draft, we appreciate your consideration of these comments. We look forward to continuing our productive dialogue in the weeks and months ahead.

Sincerely,

Jeffrey D. DeBoer
President and Chief Executive Officer