The Real Estate Roundtable

U.S. House of Representatives
Ways and Means Committee
Working Group on Real Estate Tax Reform

April 12, 2013

Overview

- Roundtable supports comprehensive pro-growth tax reform
- We are pleased to provide comments about the commercial real estate industry and tax reform in general
- We respectfully provide the following policy suggestions regarding:
  - ✓ Investment incentives:
    - – capital gain
    - – carried interest
    - – foreign investment in real property
    - – depreciation of buildings and improvements thereto
    - – investment by domestic tax-exempt entities
  - ✓ Partnership taxation
  - ✓ Energy efficiency incentives
  - ✓ Interest on debt and debt restructuring
  - ✓ Marketplace fairness

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Real Estate Tax Policy and Economic Health

- Changes in commercial real estate taxation also will affect the health of:
  - U.S. economy
  - Job creation
  - States, counties and local communities
  - Retirement savings
  - Lending institutions
  - Pension and other retirement funds

Real Estate and the U.S. Economy

- Current value of America's commercial real estate is approximately $5.1 trillion.
- This is supported by $3.06 trillion of debt, leveraged conservatively at about 60%, with $2.04 trillion of equity.

Real Estate Supports Communities

- The real estate industry accounts for nearly 1/4 of taxes collected at all levels of government (this includes income, property and sales taxes).
- Taxes from real estate ownership and transfer represent the largest source — in some cases approximately 70% — of local tax revenues, helping to pay for:
  - Schools and libraries
  - Roads and other infrastructure
  - Law enforcement
  - Other essential public services

Real Estate: Job Multiplier

- From the perspective of the national economy, real estate is one of the most important employers in the United States.
- Real estate companies are engaged in a broad array of real estate activities, generating millions of real estate-related jobs in such fields as:
  - Construction, planning, architecture, building maintenance, management
  - Environmental consulting, leasing, brokerage
  - Mortgage lending, finance, accounting and legal services
  - Investment advising, interior design and more

Commercial Real Estate

- Commercial real estate includes office buildings, warehouses, free standing retail stores, retail centers and regional shopping malls, industrial properties, hotels, convenience stores, apartment communities (market and affordable), medical centers, senior living facilities, student housing, gas and service stations and much more.
- Tax policy changes relating to the owners, developers, investors and financiers of such assets will significantly impact the U.S. economy — in ways both intended and unintended.

Capital Intensive

- Commercial real estate is a capital-intensive asset; income-producing buildings require constant infusions of capital for acquisition and construction needs, ongoing maintenance and repairs, and to address tenants' ever-changing technological requirements.
- Federal tax policy relating to interest expensing, depreciation, capital gains, foreign investment sources, entity choice, as well as state and local tax deductibility, is particularly important to strong, growing commercial real estate markets.

Entity-Level Structures

- Entities through which commercial real estate is developed, owned and financed are long-standing business models that facilitate all types and levels of job-creating investment and ownership opportunities that Americans support:
  - Partnerships, LLCs, S corporations, C corporations and REITs
- Proposals to change tax policy in any of these areas must be studied carefully for both direct and indirect effects on the real estate industry and, as a consequence, potential unintended effects across the economy.

Positive Reforms

- Positive reforms in any of these areas could spur job creation.
- For example, tax reform that recognizes and rewards suitable levels of risk taking will encourage appropriate construction and development activities, create jobs, and facilitate the refinancing of $1.7 trillion in commercial real estate mortgages maturing in the next few years.

Reform and Growth

- Some reforms might unintentionally be counter-productive to long-term economic growth.
- Of major concern are proposals that could result in substantial losses in real estate values — just as valuations are beginning to recover from the Great Recession.
- Lower property values produce a cascade of negative economic impacts, affecting property owners' ability to obtain credit, reducing tax revenues collected by the Federal, state and local governments and eroding the value of retirees' pension fund and other retirement portfolios.

Proceed with Caution - Transition Rules are Critical

- We welcome a simpler, more rational tax code.
- However, we continue to urge that comprehensive tax restructuring be undertaken with caution, given the potential for tremendous economic dislocation.
- As history illustrates, the unintended consequences of tax reform can be disastrous for individual business sectors and the economy as a whole.

A Case in Point

- The 1986 Tax Reform Act, ushered in a series of over-reaching and over-reactive policies — in some cases (such as the passive loss limitations) on a retroactive basis, making these policy changes applicable to pre-existing investments.
- Taken together, these policy changes had a destabilizing effect on commercial real estate values, financial institutions, and the Federal, state and local tax bases.
- It took years for the real estate industry to regain its productive footing, and, due to collateral damages, certain aspects of the economy have never recovered.

Tax Reform Principles

- Tax reform relating to commercial real estate should:
  - Encourage capital formation (from both domestic and foreign sources, on an equal footing) and reward appropriate risk taking
  - Closely reflect the economics of the underlying transaction — avoiding either excessive incentives or disincentives (an exception to this general rule would be incentives for low-income housing such as low-income housing tax credit)
  - Provide for a reasonable multi-year transition regime that minimizes dislocation in and disintermediation from real estate markets

Specific Real Estate Tax Reforms

- ✓ Investment incentives:
  - -- capital gain
  - -- carried interest
  - -- foreign investment
  - -- depreciation of buildings and improvements
  - -- investment by domestic tax-exempt entities
- ✓ Partnership taxation
- ✓ Energy efficiency incentives
- ✓ Interest on debt and debt restructuring
- ✓ Marketplace fairness

Capital Gain

- A lower tax rate afforded long-term capital assets is an essential ingredient in the risk-reward tradeoff that induces developers and investors to take on unique long-term risks of commercial real estate development.
- A long-term capital gain tax rate lower than the rate on ordinary income stimulates economic growth, increases domestic and international investment and most importantly helps to create and sustain new jobs.
- One of the key factors to assure strong economic growth and job creation is to encourage greater investment in the economy.
- Achieving capital gain is one of the pre-eminent goals of real estate ownership and investment. A lower tax rate on capital gain enhances the flow of capital to real estate assets and to other job-creating investments throughout the economy.
- In general, a high capital gains tax discourages savings and risk-taking and encourages investors to remain locked into old investments.

Capital Gain – Carried Interest

- The Administration and some in Congress propose to tax all carried interest gains as ordinary income if the partnership is involved in real estate, private equity, hedge or venture capital investments.
- Even worse, the proposal would apply to existing partnership investments and all family partnerships
- In fact, businesses, large or small, in all business areas use partnerships as their business entity of choice and include some form of carried interest incentive. Entrepreneurial ventures generally entail taking on significant economic risk. This partnership structure allows entrepreneurs to match their expertise and risk assumption with a financial partner and align the parties' economic interests so that entrepreneurial risk taking is viable. This partnership structure allows the parties considerable flexibility in how they share the returns from the partnership over the life of the partnership. The return-sharing ratio between the general and limited partners can, and often does, change several times throughout the life cycle of the partnership .

Capital Gain – Carried Interest

- The real estate industry utilizes partnerships with carried interests on projects ranging from small property development to large multi-billion dollar investment funds. Other industries using the same entity model include, for example: oil and gas, cellular telephone, cable television, biotech, healthcare and restaurants.
- Enactment of the proposal would be the first time that the sweat equity of an entrepreneur who is building a business would be taxed as ordinary income. It would discourage risk taking that drives job creation and economic growth. In short, it would have profound unintended consequences for main streets of cities and towns all across our country.

Capital Gain – Carried Interest

- About 15 million Americans are partners in more than 2.5 million partnerships. They manage nearly $12 trillion in assets and generate roughly $400 billion in annual income. Taxing all carried interests in partnerships as ordinary income would be a huge tax increase that would drive significant investment from the economy.
- About 45% of all partnerships are engaged in real estate investment and 60% of their income is capital gain income. Real estate general partners put "sweat equity" into their business, fund the predevelopment costs, guarantee the construction budget and financing, and expose themselves to potential litigation over countless possibilities. They risk much. Their gain is never guaranteed. It is appropriately taxed today as capital gain.

Capital Gain – Carried Interest

- In typical real estate partnerships, before a financial partner enters the picture, a developer typically spends 3-5 years and hundreds of thousands to millions of dollars in architectural, engineering, consulting and legal costs to bring land to a buildable state—through zoning, plans, studies, and approvals.
- Given that the finance partners have the most actual capital at risk, they want such risk capital (plus an agreed rate of return) returned as quickly as possible. The partnership is ideal in facilitating this because the partners can agree to pay all partnership income (in a real estate deal typically rental income) to the finance partners until their capital contribution, plus the negotiated rate of return thereon, is repaid. Thereafter, the partners can agree to share partnership income in any combination of ways they want to reflect the economics of the deal. When (and only when) the partnership assets are sold, the carried interest kicks in as a capital gain, assuming agreed upon profit targets are met, and the proceeds are shared in accordance with that agreement. In a typical real estate transaction, it is in fact only on sale that the carried interest produces capital gain.

Capital Gain – Carried Interest

- The proposal would make it more expensive to build modern shopping centers, offices and apartments, especially in long neglected neighborhoods or on land with potential environmental contamination. As a consequence, significant higher-risk development simply will not happen.
- Income derived from services is usually an amount certain, paid within the tax year (often contemporaneous with the provision of the services) and clearly acknowledged to be a fee as opposed to an investment interest. Sometimes, the income is incentive based (e.g., a bonus for exceeding a sales quota). While similar in this regard to a carried interest, it is paid in the same tax year (or the year after) the services are provided and is not long-term capital gain.

Capital Gain – Carried Interest

- A carried interest is, first and foremost, an interest in the partnership. Its amount and timing depends on the success, or lack of success, of the partnership venture. Because it is a long-term, risk–based investment, it is not paid contemporaneously, nor is it guaranteed. Regardless of paper profits that might exist throughout the course of the investment, actual profit only exists when the asset is sold.
- Achieving tax fairness is complicated. Simple solutions often are not solutions at all.

Foreign Investment

- The Foreign Investment in Real Property Tax Act of 1980 (“FIRPTA”) imposes U.S. tax on gain realized by a foreign investor on the disposition of an “interest” in U.S. real property.
- In addition to considerable administrative burdens, in some cases the FIRPTA tax can be as high as 54.5% -- an initial 35% tax on gain from real estate plus additional state tax and potentially the Branch Profits tax.
    - An “interest” in U.S. real property includes stock in a U.S. corporation where the majority of the corporation’s assets are U.S. real property.
    - Foreign investors in U.S. corporations that hold assets *other* than U.S. real property are not subject to any tax on a disposition of such stock.
- FIRPTA is unnecessary and counterproductive, discourages investment in U.S. real property to the detriment of the overall U.S. economy, and should be repealed in its entirety.

Foreign Investment

- FIRPTA's real impact - FIRPTA truly discourages foreign investment in U.S. real estate:
  - Discouraging foreign investment hurts the U.S. economy and curtails job creation
  - U.S. real property has become a less attractive investment than real property in other countries
  - Reduced demand for U.S. real property depresses values
  - Onerous tax and administrative burdens on foreign investment in U.S. real property
  - Highly complex tax regime encourages financial engineering and gamesmanship

Foreign Investment

- FIRPTA is an unnecessary and burdensome Code provision and should be repealed in its entirety.
- FIRPTA repeal will result in:
  - Increased foreign investment in U.S. real property
    - This additional investment will allow real property owners to upgrade and rehabilitate existing properties
    - Increased investment in property development and redevelopment will provide jobs and revitalize neighborhoods, as well as enabling infrastructure to be improved
  - More efficient allocation of property ownership – current owners holding on to properties solely because of FIRPTA's potential impact will be willing to transfer property to investors who can put properties to their highest and best use

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Depreciation of Buildings and Improvements Thereto

- Studies by Treasury, Congress and the real estate industry have concluded that the current depreciable lives for non-residential structures (39 years) and residential structures (27.5) exceed the useful lives of such properties.
- The depreciation period for improvements to business tenant space is 15 years (leasehold improvements) which also generally exceeds the term of the lease (typically 7 – 10 years for offices).
- We urge policymakers to reduce the period over which non-residential structures and residential structures are depreciated to 25 and 20 years, respectively.
- The appropriate depreciation period for leasehold improvements is the life of the lease; however; for simplicity purposes, the current 15-year rule should be made permanent .
- These depreciable lives also should be made applicable in determining earnings and profits, so that REITs may benefit from the change.

Investment in Domestic Real Estate by US Tax-Exempt Entities

- Similar to repealing FIRPTA to attract foreign equity investment in U.S. real estate, reviewing and modernizing the unrelated business income tax (UBIT) laws and regulations would incentivize the infusion of investment capital from pension and other retirement plans and tax-exempt foundations into the commercial real estate sector and create jobs.
- Two areas of change needed to promote real estate commerce involving US tax-exempt entities' ability to invest in US real estate without tax if leverage is used:

1. expand "qualified organization" definition under Section 514(c)(9) “fractions rule” to include IRAs, foundations and charities
2. adopt American Bar Association (“ABA”) recommendations to eliminate non-abusive problems under the fractions rule

Investment in Domestic Real Estate by US Tax-Exempt Entities

- Expand "qualified organization" definition under Section 514(c)(9) to include IRAs, foundations and charities.
- Under current law, IRAs, foundations and charities cannot acquire or improve real estate without tax if leverage is used.
- In contrast, pension plans and educational institutions are exempt from this rule under Section 514(c)(9) and may freely acquire or improve investment real estate without tax using leverage.
- Change would boost real estate commerce without loss of revenue or creating any tax abuse risk.

Investment in Domestic Real Estate by US Tax-Exempt Entities

- Adopt the ABA recommendations to eliminate non-abusive problems under the fractions rule under Section 514(c)(9).
- So called "fractions rule" under Section 514(c)(9) prevents tax abusive special allocation of losses away from tax-exempt partners.
- Regulations under the fractions rule have technical problems that prevent non-abusive real estate investment by tax-exempt investors. The ABA recommendations have been reviewed at length by Treasury and the IRS, which seem prepared to adopt many of the changes without causing any US revenue loss – but they have yet to act.

Pass Through Entities

- Businesses organized as partnerships, limited liability companies, S corporations and sole proprietorships account for more than 50% of all jobs in the United States, employing more workers than C corporations in almost every state – and about 45% of all partnerships are real estate investment partnerships
- We support maintaining the current taxation structure for businesses organized as partnerships, limited liability companies, S corporations and sole proprietorships regardless of the size of a business.

Pass Through Entities

- On March 12, 2013, the Chairman of the House Ways and Means Committee released a “discussion draft” of small business and pass through entity tax reform. The proposal presents two options, each of which would substantially change the Federal tax treatment of partnerships and S corporations:
  - ✓ Option 1 contains targeted supportable modifications to specific rules under the separate regimes
  - ✓ Option 2 combines the regimes for partnerships and S corporations, making material, and potentially troubling, changes by reference to each regime

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Pass Through Entities

- Option two would undertake a major change in the current treatment of pass through entities by eliminating the separate regimes for partnerships and S corporations and replacing those separate regimes with a single regime for qualified “pass throughs”.
- The new regime would limit the ability to specially allocate items in three broad categories: (1) ordinary items, (2) capital gain rate items, and (3) tax credits. Within each of those categories, there would be no ability to specially allocate items; instead, partners would take their proportionate share of all items allocated in any such category in a tax year.
- We are concerned with the inability to make special allocations as nearly all capital-intensive partnerships, such as those that own or develop commercial real estate, experience disproportionate distributions of cash and allocations of taxable income or loss at some point. In fact, a touchstone of the partnership allocation regulations is the principle that taxable loss is allocated so as to reflect the manner in which the corresponding economic loss would be shared by partners. The need for disproportionate distributions and allocations arises from the disparate ways in which partners contribute to the success of an enterprise—whether through management or operational skill, guaranty of the partnership's construction loan, capital contributions, or a combination.   Timing of capital contributions also affects distribution priorities among partners.

Partnership Taxation

Harmonize Overlapping Partnership Loss Limitation Regimes:

- Three separate sets of rules, each complex in its own right, limit partners' ability to deduct losses from a partnership:
  - (1) At-risk rules under §465,
  - (2) Partnership allocation rules under IRC §704(b), (c);
  - (3) Limitation of deductible losses to a partner's basis in his or her partnership interest (outside basis) under §§704(d), and 752;
    - ❖ There are also passive activity loss rules under §469; although this is a deferral vs. current deductibility issue, the concept has a significant adverse impact on potential real estate investments
- These three all essentially seek to limit deductible losses to the taxpayer's investment exposure to the business, including some measure of his or her share of borrowed capital, but each regime has rules materially different from the others. Their interaction leads to unnecessary complexity, business uncertainty, and misapplication of the rules by taxpayers and revenue agents alike.

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Partnership Taxation

- 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 trip up tax practitioners and revenue agents.

Partnership Taxation

Mistakes & Uncertainty Could be Avoided by Repealing At-Risk Rules and Modestly Harmonizing the Allocation and Basis Rules

- Purpose of the at-risk rules is adequately served by the allocation, basis loss limitation and passive activity rules.
- Much of the conflict among the partnership loss limitation regimes comes from unique technical requirements of the at-risk rules. Largely due to this complexity, enforcement of and compliance with §465 are spotty at best.
- Additionally, Sec. 731 should clarify that distributions in excess of a partner's basis are measured only at year-end after all allocations *including any special allocations*.

Energy Efficiency Incentives

- "All of the above" energy policy must include incentives to encourage energy efficiency – as well as energy creation
  - ✓ More "bang for the buck" to invest in energy savings
  - ✓ Cheaper to "save" kilowatt of energy than "create" new one
- 179D tax deduction – the energy incentive for commercial real estate
  - ✓ First enacted in 2005
  - ✓ Expires at end of 2013

Energy Efficiency Incentives

- Current 179D does not incentivize existing building retrofits
  - ✓ Standard to claim deduction not realistic for existing buildings
  - ✓ Too expensive to conduct building modeling to show hypothetical improvements ("50% over ASHRAE")
  - ✓ No sliding scale for meaningful yet modest improvements
  - ✓ Reforms are needed to make 179D usable for the entire spectrum of the real estate industry.

Energy Efficiency Incentives

- Broad coalition of real estate, manufacturing and contracting groups support 179D extension – with meaningful reforms to spur "retrofits" – and create an estimated 77,000 new jobs every 2 years
  - ✓ New construction inherently more energy efficient
  - ✓ Largest gains to be made in encouraging upgrades of existing buildings
- S. 3591 introduced last fall
  - ✓ Makes 179D a true "performance based" and "technology neutral" incentive
  - ✓ Would support retrofit "projects" – not any particular building "product" or equipment component

Energy Efficiency Incentives

- S. 3591 makes 179D more usable in 3 main ways:

  (1) Rewards deduction based on energy improvements over a building's <u>own</u> energy use baseline (not relative to "modeled" improvements over some arbitrary state code requirement)

  (2) Provides a sliding scale for reward – the higher the energy savings, the greater the deduction

  (3) Places private sector owners on equal footing with government building owners, by allowing them also to "allocate" the incentive to an architect, engineer or other party "primarily responsible" for the retrofit project

Interest on Debt

- Debt is a fundamental part of a typical real estate entity's capital structure and is often used to finance day-to-day operations and fundamental business activities like meeting payroll, buying raw materials, making capital expenditures, building new facilities, and financing asset acquisitions that allow the firm to expand as the economy improves.
- All these expenses are incurred in the ordinary course of trade or business and the interest on these loans is therefore tax deductible.
- According to the Small Business Administration, four in five small businesses use debt in their capital structure.
- The tax code is currently revenue neutral with respect to debt. Generally, each dollar of interest deducted from the borrower’s income is a dollar included in the creditor’s taxable income. Debt also creates an environment of fiscal discipline as investors carefully examine business plans prior to investing and maintain a close watch on the progress and growth of their investments.

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Interest on Debt

- Limiting interest deductibility would penalize early stage and innovative companies that rely on external financing to expand or create jobs. Such a policy change would mean that the tax code, and not investors, would be picking which companies are more likely to receive financing and which are more likely to be disregarded.
- Limiting interest deductibility will significantly increase the marginal effective tax rate on new investment and could stifle growth in the United States.
- Tax reform, however, should not come at the expense of eliminating fundamental tax principles that are essential to the conduct of business. Limiting the ability to deduct ordinary business expenses, or changing the longstanding definition of those expenses, will have a negative impact of capital growth.

Debt Restructuring Tax Rules

- General rule – If you borrow $1,000, but only repay $600, the $400 difference – "COD income" – is taxable income
- Section 108 is intended to give troubled taxpayers relief by excluding COD income if the taxpayer or the debt has a certain status
- Under current law, a debt reduction/foreclosure can trigger a tax liability for financially troubled debtors
- If the debtor has lost money – whether with a business debt or a home mortgage – how can additional taxes be due?
- Back taxes and Federal tax liens can be devastating

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Recommendation: A Return to Prior Law Section 108

- The provisions of Section 108, as enacted in 1980, should be restored
  - Re-enact the qualified business debt exception
  - Restore the equity-for-debt exception for corporations and partnerships
- Make permanent the Section 108(a)(1)(E) qualified residence exception (now set to expire after 2013)
- Clarify the rules as they apply to partnership COD income
- Update and modernize – so that exclusion, attribute reduction and deferral are available to all taxpayers

Debt Restructuring – Camp Proposal

- Agree with Chairman Camp's financial products discussion draft proposal –
  - ✓ "Phantom income" problem associated with debt modifications should be eliminated.
  - ✓ Provide new rule – the issue price of "new" modified debt instrument cannot be less than the issue price of the "old" debt instrument, reduced by the amount of principal forgiven, if any.

Marketplace Fairness

- According to estimates, in 2012 $23 billion in uncollected sales tax revenue were lost by the states and local authorities.
- As a result, cities, counties and states are turning to tax increases, other fees and new taxes, many of which disproportionately impact commercial real estate, to make up the difference.
- We need to have a modern marketplace that is vibrant, viable and equitable for all.
- The time has come to bring sales tax laws into the 21st Century.

Tax Reform

- The appropriate tax reform policy can help commercial real estate:
  - Create and sustain jobs
  - Assist in the financing of local community betterment
  - Improve retirement savings for Americans
  - Reduce energy consumption
  - Facilitate needed infrastructure improvements
- The Real Estate Roundtable pledges to help the Ways and Means Committee reach these goals.

About The Real Estate Roundtable

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 with the leaders of major national real estate trade associations to jointly address key national policy issues relating to real estate and the overall economy. By identifying, analyzing and coordinating policy positions, The Roundtable's business and trade association leaders seek to ensure a cohesive industry voice is heard by government officials and the public about real estate and its important role in the global economy. 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.

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