



## The Real Estate Roundtable

Statement for the Record

### **Hearing on Business Tax Reform**

Committee on Finance  
U.S. Senate

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September 19, 2017

Chairman Hatch, Ranking Member Wyden, and members of the committee, my name is Jeffrey DeBoer and I am President and Chief Executive Officer of The Real Estate Roundtable. Thank you for the opportunity to testify this morning on business tax reform on behalf of Roundtable members and the real estate industry.

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 12 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 2.5 million hotel rooms. Participating trade associations represent more than 1.5 million people involved in virtually every aspect of the real estate business.

We agree with the members of this committee, House leaders, and the President that the time to reform the tax code is now. We share your commitment to pro-growth tax reform that will move our economy forward and help produce better jobs and bigger paychecks for all Americans. Our industry has appreciated the open dialogue and opportunity to work constructively with Members and staff of this committee to ensure that tax reform achieves its full potential.

My comments are offered in the spirit of support for the tax reform effort, and they are aimed at ensuring the legislation successfully spurs economic growth without unintentionally discouraging entrepreneurship or creating unnecessary economic and market risks.

### **REAL ESTATE AND THE ECONOMY**

Real estate is deeply interwoven in the U.S. economy and the American experience, touching every life, every day. Millions of Americans share in the ownership of the nation's real estate, and it is a major contributor to U.S. economic growth and prosperity. Real estate plays a central role in broad-based wealth creation and savings for investors large and small, from homeowners to retirees invested in real estate via their pension plans.

Commercial real estate provides the evolving physical spaces in which Americans work, shop, learn, live, pray, play, and heal. From retail centers to assisted living facilities, from multifamily housing to industrial property, transformations are underway in the “built environment.” Investment in upgrading and improving U.S. commercial real estate is enhancing workplace productivity and improving the quality of life in our communities.

Among its many and varied economic contributions, the real estate industry is one of the leading job creators in the United States, employing over 13 million Americans—more than one in every 10 full-time U.S. workers—in a wide range of well-paying jobs. Real estate companies are engaged in a broad array of activities and services. This includes jobs in construction, planning, architecture, building maintenance, management, environmental consulting, leasing, brokerage, mortgage lending, accounting and legal services, agriculture, investment advising, interior design and more.

Commercial real estate encompasses many property types, from office buildings, warehouses, retail centers and regional shopping malls, to industrial properties, hotels, convenience stores, multifamily communities, medical centers, senior living facilities, gas stations, land and more. Conservatively estimated, the total value of U.S. commercial real estate in 2016 was \$13 to \$15 trillion, a level that roughly matches the market cap of domestic companies on the New York Stock Exchange. Investor-owned commercial properties account for roughly 90 percent of the total value, with the remainder being owner-occupied. Based on the latest data available from the Federal Reserve, U.S. commercial real estate is conservatively leveraged with about \$3.8 trillion of commercial real estate debt.

Industry activity accounts for nearly one-quarter of taxes collected at all levels of government (this includes income, property and sales taxes). Taxes derived from real estate ownership and its sale/transfer represent the largest source — in some cases approximately 70 percent — of local tax revenues, helping to pay for schools, roads, law enforcement and other essential public services. Real estate provides a safe and stable investment for individuals across the country, and notably, retirees. Over \$370 billion is invested in real estate and real estate-backed investments by tax-exempt organizations (pension funds, foundations, educational endowments and charities).

Commercial real estate is a capital-intensive asset, meaning that income-producing buildings require constant infusions of capital for acquisition and construction needs, ongoing repairs and maintenance, and to address tenants’ ever-changing technological requirements. Every homeowner in America who has had to repair a roof or to replace a furnace understands and appreciates that buildings are not a one-time, fixed expense. Real estate development, and the real estate improvements necessary for a building to avoid obsolescence, serves as a constant and powerful economic multiplier. Real estate capital expenditures ripple through the economy—creating jobs and generating economic growth.

Real estate investment is a long-term commitment and involves time horizons measured in five to ten year increments, or longer—not the three-month quarters that other industries and asset classes use to measure their performance. Consequently, from small towns to urban centers, real estate ownership in the United States represents a positive, bullish bet on America’s economic future.

At the same time, the health and stability of U.S. real estate is heavily dependent on broader trends in the economy. Debt and deficits matter to real estate because of their impact on interest rates, the cost of borrowing, and the availability of private capital for investment and job creation.

On one hand, some tax policies may cease to be pro-growth if they are financed through an increase in the federal deficit. On the other hand, some revenue-raising options under discussion would slow growth and put downward pressure on wages and employment, so revenue neutrality for its own sake is not desirable.

Ultimately, the supply of real estate should be responsive to demand in order to support sustainable economic growth, and demand for real estate correlates with the overall level of economic activity. Thus, where goes the economy, so goes real estate. And where goes real estate, so goes the economy. The two are inextricably linked.

## **PRINCIPLES FOR SUSTAINABLE, PRO-GROWTH BUSINESS TAX REFORM**

The real estate industry agrees that tax simplification and reform is needed and long overdue. We should restructure our nation's tax laws to unleash entrepreneurship, capital formation, and job creation. At the same time, Congress should undertake comprehensive tax reform with caution, given the potential for tremendous economic dislocation. Tax policy changes that affect the owners, developers, investors and financiers of commercial real estate will have a significant impact on the U.S. economy, potentially in unforeseen ways.

A broad-based acceleration of economic growth through tax reform would boost real estate construction and development and spur job creation. However, Congress should be wary of changes that result in short-term, artificial stimulus and a burst of real estate investment that is ultimately unsustainable and counterproductive. Real estate investment should be demand driven, not tax driven. In short, we should avoid policies that create a "sugar high" that is fleeting and potentially damaging to our future economic health.

Because of the long-term commitment required in real estate investment, we are deeply concerned with how tax changes will affect jobs, wages, and economic activity not just tomorrow, but well into the future. In order to improve the economy's trajectory, growth should be predicated on sound reforms that change underlying economic conditions.

Fortunately, today's commercial real estate markets are grounded in strong fundamentals, as indicated by generally low vacancy rates, positive growth of rents and stable net operating income. By most measures, commercial real estate conditions accurately reflect market supply and demand.<sup>1</sup> Sources of equity and debt capital are largely available for economically viable real estate projects. In some parts of the country and in certain markets, initial signs of oversupply are starting to emerge. These signs are typical and expected in a healthy real estate cycle.

We urge the Finance Committee to be mindful of how proposed changes in commercial real estate taxation could dramatically affect not only real estate investment activities but also job growth, retirement savings, lending institutions, pension funds, and, of course, local communities.

Positive reforms will spur job-creating activity. For example, tax reform that recognizes and rewards appropriate levels of risk taking will encourage productive construction and development activities, ensuring that real estate remains an engine of economic activity. Tax reform can also spur

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<sup>1</sup> The Real Estate Roundtable, *Sentiment Index: Second Quarter 2017* (May 5, 2017), available at: <http://www.rer.org/Q2-2017-RER-Sentiment-Index>.

job creation, and assist the nation in achieving energy independence, by encouraging capital investments in innovative and energy-efficient construction of buildings and tenant spaces. Repealing the *Foreign Investment in Real Property Tax Act (FIRPTA)* would open up new sources of private capital for U.S. real estate and infrastructure projects. Authorizing States to impose sales tax collection requirements on remote sellers would end harmful tax discrimination against brick and mortar retailers and improve the economic well-being of local communities.

Alternatively, some reforms might prove counter-productive to long-term economic growth. Of major concern are proposals that could result in substantial losses in real estate valuation. Lower values could result from artificially stimulating excess supply, or adopting policies that increase the cost of capital through higher borrowing costs. Lower property values produce a cascade of negative economic impacts, affecting property owners' ability to obtain credit, reducing tax revenues collected by local governments and eroding the value of retirees' pension fund portfolios.

Thus, as much as we welcome a simpler, more rational tax code — and any associated improvements in U.S. competitiveness abroad — 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 is the *Tax Reform Act of 1986*, which ushered in over-reaching and over-reactive policies — in some cases on a retroactive basis. Significant, negative policy changes were applied to pre-existing investments. Taken together, these changes had a destabilizing effect on commercial real estate values, financial institutions, the federal government and state and local tax bases. It took years for the overall industry to regain its productive footing, and certain aspects of the economy never recovered.

A nostalgia for the *Tax Reform Act of 1986* has grown and spread in Washington over the years. The *1986 Act* is frequently cited as the model that 21st century tax reform should strive to mimic. The actual economic evidence is much less favorable.<sup>2</sup> If there is a major lesson we can draw from the *1986 Act*, perhaps it is this: revenue-raising policy changes tend to be much more enduring than reductions in tax rates, which are more easily undone to accommodate changing needs related to fiscal policy.<sup>3</sup>

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<sup>2</sup> Both economic growth and job creation slowed dramatically in the United States for a number of reasons after the *Tax Reform Act of 1986* took effect. In the five years before the legislation was adopted (1982-86), the United States' real rate of economic growth averaged 3.55 percent. In the five years after enactment of the 1986 Act (1987-1991), the United States' economic growth rate averaged 2.64 percent. [World Bank National Accounts Database](#) (accessed Sept. 14, 2017). Similarly, in the five years prior to its enactment (1982-1986), the United States created an average of 160 thousand jobs per month. In the five years after its passage (1987-1991), the United States created 130 thousand jobs per month, or 30 thousand fewer than before its enactment. U.S. Department of Labor, Bureau of Labor Statistics, [Current Employment Statistics Survey](#) (accessed Sept. 14, 2017).

<sup>3</sup> The 28 percent maximum individual income tax rate in the *Tax Reform Act of 1986* lasted three years before increasing to 31 percent in a bipartisan budget agreement. Three years later, in 1993, the maximum income tax rate increased again to 39.6 percent. In contrast, the base broadeners, such

We believe the four principles below should guide and inform your efforts to achieve a significant, pro-growth overhaul of the nation's tax code:

1. Tax reform should encourage capital formation (from domestic and foreign sources) and appropriate risk-taking, while also providing stable, predictable, and permanent rules conducive to long-term investment;
2. Tax reform should ensure that tax rules closely reflect the economics of the underlying transaction — avoiding either excessive marketplace incentives or disincentives that distort the flow of capital investment;
3. Tax reform should recognize that, in limited and narrow situations (*e.g.*, low-income housing and investment in economically challenged areas), tax incentives are needed to address market failures and encourage capital to flow toward socially desirable projects; and
4. Tax reform should provide a well-designed transition regime that minimizes dislocation in real estate markets.

In short, rational taxation of real estate assets and entities will support job creation and facilitate sound, environmentally-responsible real estate investment and development, while also contributing to strong property values and well-served, livable communities.

## **POTENTIAL ELEMENTS OF BUSINESS TAX REFORM AND THEIR IMPACT ON REAL ESTATE**

In June of last year, House Ways and Means Committee Chairman Kevin Brady (R-TX), House Speaker Paul Ryan (R-WI), and the House Republican Conference put forward *A Better Way*, a bold tax reform proposal aimed at creating a modern tax code. We support the Blueprint's underlying objectives, including the desire to reform the tax system to promote economic growth, capital formation, and job creation. In addition, this committee has explored several tax reform options, including corporate tax integration. Senator Wyden has released a number of tax reform discussion drafts related to various issue areas. In April, the President's economic team released a one-page outline of the Administration's tax reform priorities. In July, Congressional leaders, the Treasury Secretary, and the Director of the National Economic Council issued a joint statement identifying several areas of agreement. While the details of tax reform remain uncertain, these events have shed light on the potential contours of comprehensive tax legislation. The remainder of my testimony will focus on specific elements of business tax reform under consideration. Of course, our views and input will continue to evolve as additional information and details are made available.

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as the lengthening of cost recovery schedules and limitations on passive activity losses, became permanent fixtures of the tax code.

## **The Business Interest Deduction – An Ordinary and Necessary Expense Critical to Real Estate Ownership, Development and Financing**

The House Blueprint and other reform proposals have advocated limiting or repealing the deductibility of net interest expense for business-related debt. Restrictions on interest deductibility would cause enormous damage to U.S. commercial real estate by dragging down property values and discouraging new investment.

Access to financing and credit is critical to the health of U.S. real estate and the overall economy. As a general matter, business interest expense is appropriately deducted under the basic principle that interest is an ordinary and necessary business expense. For real estate in particular, because the vast majority of real estate is held in pass-through form, the interest deduction does not result in a tax-induced distortion in investment financing decisions.

The ability to finance productive investment and entrepreneurial activity with borrowed capital has driven economic growth and job creation in the United States for generations. America's capital markets are the deepest in the world and provide our economy with a valuable competitive advantage.

Borrowing is not limited to large companies—four out of five small businesses rely on debt financing. Businesses rely on credit for working capital and to weather shifts in demand. Limiting the deductibility of interest would increase the cost of capital, discouraging business formation and making it harder to grow into larger businesses. Over time, rising interest rates will magnify the harm, potentially leading to greater financial volatility and higher default rates.

The notion that business interest should be deductible is deeply ingrained in our economic system and precedes the modern income tax itself. The corporate income tax of 1894 included a deduction for business interest. In both an income tax system and a cash flow tax system, business interest expense is appropriately deducted under the basic principle that interest is an ordinary and necessary business expense. Any economic bias in favor of debt-financed investment principally relates to the tax penalty on the shareholders of C corporations, who are double-taxed on their equity investments. Real estate is held typically in pass-through form, and the interest deduction does not result in a tax subsidy for debt-financed real estate investment.

Repealing or imposing limits on the deductibility of business interest would fundamentally change the underlying economics of business activity, including commercial real estate transactions. This could lead to fewer loans being refinanced, fewer new projects being developed, and fewer jobs being created. Legislation altering the tax treatment of existing debt could harm previously successful firms, pushing some close to the brink of insolvency or even into bankruptcy. By increasing the cost of capital, tax limitations on business debt could dramatically reduce real estate investment, reducing property values across the country, and discouraging entrepreneurship and responsible risk-taking.

The burden of changing the deductibility of interest may fall disproportionately on entrepreneurs and small developers—those most likely to own properties in small and medium-sized markets—because they use greater leverage to finance their activities and lack the deep portfolio of assets to absorb the losses generated from expensing. Restrictions may also impede efforts to attract private capital for infrastructure investment.

Private sector economists have modeled for the industry the impact that elimination of the deductibility of business interest would have on real estate investment and property values. They examined tax reform based on the rates and structure of the House Blueprint, but without the immediate expensing of structures. Their research suggests the negative impact on property values and the after-tax returns on real estate investment would be severe. For all of these reasons, Congress should ensure that tax reform preserves the current tax treatment of business interest.

### **Cost Recovery and the Expensing of Capital Investment – Tax Rules Should Track the Actual Economics of Real Estate Ownership**

Rather than taxing businesses on their net income, the House Blueprint seeks to tax businesses on their net cash flow. For a domestic business, the full cost of a new investment would be recovered (deducted) immediately, rather than recovered (depreciated) over the economic life of the investment. The underlying expectation is that the shift to cash flow taxation will spur growth by reducing the tax burden on new investment. While the joint statement in July appeared to move away from a complete cash flow business tax system, it did promise “unprecedented” expensing of capital investment.

Economic studies suggest that expensing in the abstract is a powerful, pro-growth tax policy. Personal property and certain real estate assets already benefit from accelerated and bonus depreciation. Today, 90 percent of the cost of an investment in three-year property is recovered for tax purposes within the first 18 months of its use. Five-year property is 78 percent recovered in the first 18 months. Even seven-year property is nearly 70 percent recovered in the first 18 months.<sup>4</sup> Expensing these short-lived asset classes makes sense. Current tax policy is already well on the way towards the expensing of equipment and machinery, and full expensing of these assets may offer significant tax simplification advantages. Alternatively, the Committee could consider proposals aimed at simplifying cost recovery for short-lived assets, such as Senator Wyden’s pooling proposal.

However, real estate is different from these other capital assets. Structures are long-lived, require constant infusions of capital, and typically sell for a gain. Thus, real estate is subject to much longer recovery periods and slower recovery methods. Expensing real estate would constitute a much more dramatic shift from current law with unknown consequences. The challenges associated with transitioning real estate to an expensing regime are immense and, likely, prohibitively costly.

The Tax Foundation’s own analysis of the economic impact of immediate expensing reveals that nearly 73 percent of the boost to economic growth generated from the full expensing of capital investment would come directly from new real estate construction, development, and investment.<sup>5</sup> While real estate represents a large and important share of the U.S. economy, it is not 3/4 of the overall pie. The Tax Foundation analysis suggests that the boost to GDP from immediate expensing would not drive a broad-based, demand-driven increase in economic activity. On the contrary, it

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<sup>4</sup> David Mericle & Dan Stuyven, [Corporate Tax Reform: Trading Interest Deductibility for Full Capex Expensing](#) (Goldman Sachs Economics Research, Nov. 30, 2016). See also Ryan Corcoran et al, [Understand Common Complexities when Applying Bonus Depreciation](#), RSM Insight Article (Feb. 7, 2017).

<sup>5</sup> Stephen J. Entin, [Tax Treatment of Structures Under Expensing](#) (May 24, 2017).

suggests that any boost to short-term growth would stem from an untested tax policy that is likely to over-stimulate real estate markets.

The industry concerns with expensing are based on historical experience. Accelerated depreciation of real estate in the early 1980s led to tax driven, uneconomic investment. Tax-motivated stimulation of real estate construction that is ungrounded in sound economic fundamentals, such as rental income and property appreciation expectations, creates imbalances and instability in real estate markets. No other major country in the world has immediate expensing of real estate. The market implications of expensing real estate are risky, untested, and unpredictable. The negative consequences could harm state and local communities (through reductions in state and local property tax revenue), the financial security of retirees (through pension investments tied to real estate), and the banking system (through the declining value of real estate on bank balance sheets and systemic risk to the financial system).

The House Blueprint proposes to deviate from cash flow taxation in two key ways that would have critical implications for real estate. First, land would not qualify for immediate expensing, only the value of structures. Second, as discussed above, businesses could not deduct currently their net interest expense. As a result, two major expenses associated with investing in real estate—the cost of the underlying land and the cost of borrowing capital to purchase the real estate—would be excluded from the basic architecture of the cash flow tax system.

Land represents a major share, on average roughly 30 percent, of the value of real estate. The House Blueprint offers no express rationale for the exclusion of land from immediate expensing. The two suggestions offered informally to-date have been that land is a “non-wasting” asset and “we’re not making any more of it.” However, the actual economic life of an asset and its status as a manufactured good is irrelevant to a system that seeks to tax net cash flow. Under the Blueprint’s own terms, land should qualify for expensing. Denying taxpayers’ ability to expense land would create the very same economic distortions that the Blueprint is seeking to remove from the tax code. It would shift resources to other asset classes for reasons that are purely tax-motivated. In addition, it would create new geographic disparities and distortions based on the relative share of land in the cost of real estate.

Current cost recovery rules do need reform. The real estate industry favors tax rules that closely reflect the economics of transactions. Existing depreciation schedules are too long. The Massachusetts Institute of Technology (MIT) recently conducted a comprehensive study on the rate of economic depreciation for commercial real estate.<sup>6</sup> MIT analyzed over 120,000 actual transactions and 13,000 land/development sites and developed a model of the entire life cycle of commercial property. For the first time, ongoing capital expenditures were added to the depreciation analysis. The research makes great strides in separating the value of land from the value of structures. The MIT study controlled for property and location characteristics much more extensively than any prior published research. The study is a tremendous improvement over prior government studies, which rely on data from the 1960s and 1970s. The bottom line is that the appropriate straight-line depreciations periods for real estate should be closer to 20 years, not 27.5 or

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<sup>6</sup> Professor David Geltner and Sheharyar Bokhari, [\*Commercial Buildings Capital Consumption in the United States\*](#), (MIT Center for Real Estate, Nov. 2015); see also Andrew B. Lyon & William A McBride, [\*Tax Policy Implications of New Measures of Building Depreciation\*](#), TAX NOTES (June 20, 2016).



39 years. Shortening the straight-line depreciation of real estate to 20 years, rather than expensing, would spur investment that is sustainable and economically sound.

With respect to depreciation “recapture,” the tax law should continue to recognize that a portion of the income received on the sale of real estate reflects the appreciation of the underlying land and is appropriately taxed at the reduced capital gains rate.

### **Pass-Through Reform: Tax Changes Should Promote Growth and Entrepreneurship for All Forms of Business Activity**

Our pass-through regime is a competitive strength of the U.S. tax system, not a burden. Entity choice is a differentiator that contributes to our entrepreneurial culture. The expansion of the pass-through sector has allowed American businesses to avoid the rigid nature of the corporate form and its many demands on legal structure and governance that are unrelated to tax considerations. Partnership tax rules promote job creation by increasing business flexibility and facilitating the pooling of expertise, capital, and know-how under one roof. Partnerships can allocate the risks and rewards of the enterprise as they choose, provided the distribution of profits and losses have substantial economic effect. The result is a more dynamic business environment that promotes innovation, productivity, and appropriate levels of risk taking that are responsive to the needs of both limited investors and general partners.

Real estate investment, new construction and development, and rental income constitute a significant share of pass-through business activity. Half of the country’s nearly four million partnerships are real estate partnerships. Pass-through entities (partnerships, LLCs, and S corporations), as well as real estate investment trusts (REITs), are ideal for real estate investment because they give investors flexibility in how they structure the risks and rewards of the business.

These partnerships include a wide variety of arrangements that range from two friends who purchase, improve, and lease a modest rental property to a large private real estate fund that raises capital from sophisticated institutional investors. Similarly, listed REITs provide the opportunity for small investors to invest in large scale, diversified real estate operations using the same single tax system available to partners in partnerships.

Recent tax reform proposals from Congressional leaders and the Administration would establish a special tax rate applicable to the business income of pass-through entities and sole proprietorships. Care should be taken when creating a new rate structure for pass-throughs, including REITs, to avoid an entity level tax or arbitrary rules that penalize general partners or raise the tax burden on carried interest.

The pass-through rate should seek to spur economic growth and job creation by reducing the tax burden on business formation and entrepreneurship. With this in mind, a special tax regime for pass-through entities should take into account the types of activity and income that most commonly arise in noncorporate form. The pass-through rate should avoid “cliffs”, phase-outs, and carve-outs that create new economic distortions, discourage business growth, or aim to steer investment to certain government-favored activities. Similarly, the pass-through rate should avoid asset or revenue tests that ignore differences in the capital intensity and financing structures of certain industries.

Further, tax reform should maintain equivalence with respect to the taxation of rent and interest, whether the rent or interest is collected through a partnership, a limited liability company, an

S corporation, or a REIT. Under current law, a dollar of rental or interest income, whether received through a REIT or a pass-through entity such as a partnership, has the same rate, character and timing for tax purposes. A shift away from equivalence would discriminate against REIT-based rent or interest received by owners of the REITs, even though REITs are not permitted to keep the rent or interest and must pay it out annually to owners.

Lastly, the pass-through rate should avoid changes that unintentionally reduce incentives for entrepreneurial risk-taking and capital formation. For example, the pass-through rate should preserve a partnership's ability to extend participation in the capital appreciation of the business and its assets to a general partner who bears risk and contributes sweat equity. The character of income should continue to be determined at the partnership level.

The Real Estate Roundtable's Tax Policy Advisory Committee has produced a white paper that suggests one possible approach for how to design a reduced tax rate applicable to pass-through business income.

In short, rather than specifically seeking to measure reasonable compensation or create an arbitrary rule that taxes a specific percentage of pass-through income as ordinary and a percentage at the business rate, the proposal looks at the relationships between the partners. If a partner spends only a *de minimis* number of hours providing services, then all of the partner's income is taxed at the pass-through rate. If there are limited partners earning the same return as the partner providing services (i.e., providing a "benchmark"), then all the service partner's income is taxed at the pass-through rate. Finally, if there is no benchmark provided by outside investors, then the service partner would qualify for the pass-through rate to the extent of a specified return on investment (perhaps 12 percent). Amounts above the specified percentage would be taxed as ordinary income.

This approach would provide greater certainty to taxpayers at the outset of a business venture. It would eliminate many of the administrative challenges associated with measuring reasonable compensation and create fewer opportunities for abuse. The white paper acknowledges that there may be situations where an approach based on reasonable compensation or other factors may be appropriate and more equitable. The proposal only relates to the operating income of a pass-through business.

### **Capital Gains and Entrepreneurial Risk Taking – A Key Differentiator that Encourages Vibrant and Dynamic Economic Growth**

The tax code has historically encouraged and rewarded risk taking and entrepreneurship, and our tax rules have recognized that risk can involve much more than the contribution of capital or cash. Low capital gains tax rates help stimulate economic growth, increase investment, and create jobs. In addition to encouraging risk-taking and entrepreneurship—core strengths of the American economic model—low capital gains rates reduce the tax-driven "lock up" of assets that prevents properties from being put to their best and most efficient use. Low capital gains taxes also minimize distortions that result from taxing inflation-induced, uneconomic gains.

Because of the capital-intensive nature of long-lived real estate assets, real estate partnerships often bring together (1) a general partner who manages the business in exchange for an annual management fee and a share of the profits and (2) investors who serve as limited partners and contribute capital. Incorporating "carried interest" into the partnership structure allows entrepreneurs

to match their expertise and risk assumption with financial partners and aligns the parties' economic interests so that entrepreneurial risk taking is viable.

Tax reform should preserve the longstanding rule that determines the character of partnership income at the partnership level. Changes to carried interest taxation would instill substantial uncertainty in the marketplace and have a chilling effect on capital investment. Congress should reject legislation that specifically targets capital gain on real estate sales (including carried interest), and any comprehensive tax restructuring should continue to encourage capital formation and appropriate entrepreneurial risk taking for the benefit of the broader economy and job creation.

### **Like-Kind Exchanges: A Valuable Tool for Business Expansion, Growth, and Job Creation**

Under current law, section 1031 of the tax code ensures that taxpayers may defer the immediate recognition of capital gains when property is exchanged for property of a like kind. In order to qualify for full tax deferral, a like-kind exchange transaction must involve property used in a trade or business, or held as an investment, and all proceeds (including equity and debt) from the relinquished property must be reinvested in the replacement property. Section 1031 is used by all sizes and types of real estate owners, including individuals, partnerships, LLCs, and corporations. While the House Blueprint does not expressly address like-kind exchanges, we understand some policymakers view immediate expensing as a viable replacement for section 1031 of the tax code. We disagree.

Real estate like-kind exchanges generate broad economic and environmental benefits, and Section 1031 should be preserved without new limitations on the deferral of gains. Exchanges spur greater capital investment in long-lived, productive real estate assets and support job growth, while also contributing to critical land conservation efforts and facilitating the smooth functioning of the real estate market. Without Section 1031, many of these properties would languish underutilized and short of investment because of the tax burden that would apply to an outright sale. Recent academic research analyzing 18 years of like-kind exchange transactions involving real estate found that they lead to greater capital expenditures, investment, and tax revenue while reducing the use of leverage and improving market liquidity.<sup>7</sup> Another study by EY concluded that new restrictions would increase the cost of capital, discourage entrepreneurship and risk taking, and slow the velocity of investment.<sup>8</sup> As currently understood, the Blueprint would not fully replicate the benefits of section 1031, particularly to the extent that the land component of real estate remains ineligible for immediate expensing.

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<sup>7</sup> Professors David C. Ling (Univ. Fla.) and Milena Petrova (Syracuse U.), *The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate* (June 2015), available at: [http://warrington.ufl.edu/departments/fire/docs/paper\\_Ling-Petrova\\_EconomicImpactOfRepealingOrLimitingSection1031.pdf](http://warrington.ufl.edu/departments/fire/docs/paper_Ling-Petrova_EconomicImpactOfRepealingOrLimitingSection1031.pdf).

<sup>8</sup> EY, *Economic Impact of Repealing Like-Kind Exchange Rules* (Nov. 2015), available at: <http://www.1031taxreform.com/1031economics>.

## **State and Local Tax Deduction: Vital to Economic Health and Well-Being of Local Communities**

State and local taxes are the principal source of financing for schools, roads, law enforcement and other infrastructure and public services that help create strong, economically thriving communities. Throughout the country, real estate is the largest contributor to the local tax base. Most state and local taxes, including real estate taxes, are deductible from federal income. Eliminating the deductibility of state and local taxes could disrupt demand for commercial real estate in many parts of the country while raising taxes on millions of Americans. It would shift power away from local communities in favor of the federal government. The deductibility of state and local taxes is grounded in the Constitution, federalism, and states' rights. The state and local tax deduction prevents an erosion of local governance and decision-making by prohibiting the federal government from double-taxing amounts already taxed at the state and local level. The burden of the change will fall disproportionately on those regions that generate the most tax revenue for the federal government—and the reduced demand for commercial real estate in certain regions could lower property values and limit the ability of the industry to continue creating jobs and driving economic growth.

## **Transition Rules/Technical Adjustments: Tax Reform Must Avoid Past Mistakes, Provide Well-Designed Transition Regime**

The \$13-15 trillion of existing commercial real estate stock and \$3.8 trillion of commercial real estate mortgage debt creates immense transition challenges for tax reform. The stock of existing commercial real estate is more than 12 times the size of total annual private investment in equipment and machinery. Retroactive tax changes and poorly designed transition rules in the *Tax Reform Act of 1986* triggered a real estate depression and economic recession. Those reforms (primarily, the passive activity loss rules) were minor compared to the types of changes contemplated in the House Blueprint. Grandfathering existing investment under the current rules, alone, is not sufficient if new real estate investment is subject to a dramatically different regime. Tax reform should provide a well-designed transition regime that minimizes dislocation in real estate markets.

Additionally, care should be taken to adjust the REIT rules appropriately to ensure that the Congressional intent to allow average investors to access high quality commercial real estate is not hampered.

## **Foreign Investment in Real Property Tax Act (FIRPTA): Reform Could Boost U.S. Real Estate and Infrastructure by Repealing Outdated Barriers to Foreign Capital**

The punitive *Foreign Investment in Real Property Tax Act (FIRPTA)* regime subjects gains on foreign equity investment in U.S. real estate or infrastructure to a much higher tax burden than applies to a foreign investor purchasing a U.S. stock or bond, or an investment in any other asset class. In addition to the tax burden, the withholding and administrative filing requirements associated with *FIRPTA* are frequently cited by foreign taxpayers as principal reasons for avoiding the U.S. real estate market. *FIRPTA* is a major impediment to greater private investment in both U.S. real estate and infrastructure.

In 2015, Congress passed the most significant reforms of *FIRPTA* since its passage in 1980. Congress should build on the recent success by repealing *FIRPTA* outright as part of tax reform. Unleashed by *FIRPTA*'s repeal, capital from abroad would create jobs by financing new real estate developments, as well as the upgrading and rehabilitation of existing buildings. Architects, engineers, construction firms, subcontractors, and others would be put to work building and improving commercial buildings and infrastructure.

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Because commercial real estate is ubiquitous, it is easy to overlook its positive connection to the fabric of our nation. Commercial real estate is where America lives, works, shops, plays and invests. The right tax policy can, for the benefit of all Americans, help commercial real estate: create and maintain good jobs, lift retirement savings, reduce energy consumption, and improve the quality of life in local communities.

The Real Estate Roundtable is fully committed to working with the Senate Committee on Finance to achieve a bold business tax reform outcome that serves the overall economy. We appreciate your consideration of these issues.