The Real Estate Roundtable

Real Estate Tax Issues and Budget Reconciliation Legislation

September 17, 2021

On September 15, 2021, the House Ways and Means Committee voted to advance the final pieces of the $3.5 trillion reconciliation bill that fall under its jurisdiction.

Several tax proposals put forward by the Administration in April as part of its Build Back Better agenda would directly increase the tax burden on real estate investment and consequently hurt property values, local government budgets, and real estate's ability to continue supporting job creation and economic growth. The tax bill that advanced this week does not include narrow or discriminatory tax increases on real estate, such as restrictions on real estate like-kind exchanges. In addition, the Ways and Means bill revised other proposed tax increases that could affect real estate and other productive activities, such as changes in the capital gains rate.

Below is a summary of real estate-related tax issues in the House Ways and Means Committee legislation.

- **Real Property Like-Kind Exchanges.** The Ways and Means bill fully preserves taxpayers' ability to defer capital gain when exchanging real property for another like-kind property. The President's Budget proposed capping the deferral of gain through like-kind exchanges to no more than $500,000 annually in the case of an individual (and $1 million annually in the case of a joint return). An estimated 10 to 20 percent of all commercial real estate transactions involve at least one party who is engaged in a like-kind exchange.

- **Step-Up in Basis and Taxation of Gains at Death.** The Ways and Means bill preserves the step-up in basis that applies to built-in capital gain when real estate is transferred from a decedent to an heir. In addition, the Ways and Means bill does not impose capital gains tax on appreciated real estate when transferred by a decedent or donor. The Ways and Means bill does lower the estate tax exemption amount to its pre-TCJA levels ($5 million, indexed for inflation). The President's Budget proposed replacing the step-up in basis at death with a new regime – one that would impose capital gains tax on the built-in gain in appreciated property when it is transferred (with limited exceptions for family-owned businesses). In those cases, the decedent's adjusted basis would carry over rather than step up to its fair market value; the heirs would pay tax on the entire gain if the family ever sold the property or no longer owned and operated the business themselves.

- **Capital Gains.** The Ways and Means bill increases the maximum capital gains rate from 20 percent to 25 percent. The provision is effective for sales and exchanges after its date of introduction (*i.e.,* September 13, 2021). The President's Budget proposed increasing the capital gains rate to 39.6 percent to create parity between the tax rate on ordinary income and capital gains. The President's budget would have applied the capital gains tax increase retroactively to sales and exchanges after April 28, 2021.

- **Real Estate Carried Interest.** The Ways and Means bill generally extends from 3 years to 5 years the holding period for partnership gain attributable to a profits interest (carried interest) to qualify for the long-term capital gains rate. However, the bill preserves the current 3-year holding period for capital gain related to a carried interest in a real property trade or business. The current 3-year holding period was enacted in the *Tax Cuts and Jobs Act (TCJA) of 2017*. The President's budget proposed converting all carried interest income from a real estate partnership to ordinary income subject to the maximum individual income and self-employment tax rates.

- **Pass-Through Business Income Deduction.** The Ways and Means bill limits the maximum deduction available for pass-through business income under section 199A to no more than $400,000 for an individual (and $500,000 in the case of a joint return). In effect, the 20 percent deduction would apply to no more than $2 million of qualifying income for an individual or $2.5 million for a married couple. The President's Budget did not include a new limitation on section 199A. The pass-through business income deduction was enacted in the *TCJA*, alongside the corporate tax cut, to provide tax relief to pass-through businesses that employ workers and invest capital in productive, depreciable assets like real estate.

- **Net Investment Income Tax.** The Ways and Means bill would apply the 3.8 percent net investment income tax to capital gain, dividends, interest, and income (including rents) derived from a trade or business, regardless of whether the taxpayer is active or passive in the activity. In effect, it broadly extends the tax to income earned by limited partners in partnerships, real estate professionals who materially participate in a real estate business, and S corp. shareholders. The tax would apply to the extent that the taxpayer's income exceeds $400,000 (individual) or $500,000 (married couple). A similar proposal was included in the President's budget.

- **Affordable Housing.** The Ways and Means bill dedicates over $29 billion in revenue over 10 years towards an expansion of the low-income housing tax credit (LIHTC). The LIHTC reforms include a 50% increase in the allocation to States of the 9% credit for new construction, phased in over four years. From 2022-2028, the bill also would allow properties that are financed with a smaller percentage of tax-exempt bonds (25% minimum, rather than 50%) to still claim the LIHTC with respect to the entire eligible basis of the building. Other provisions increase the credit amount for low-income housing: (1) serving extremely low-income tenants, (2) located in rural areas, or (3) financed with tax-exempt bonds if deemed by the State to be necessary for financial feasibility.

- **Infrastructure Financing.** The Ways and Means bill dedicates nearly $42 billion in revenue to promote private investment in infrastructure projects. The innovative tax measures include a new direct pay qualified infrastructure bond that offsets 35% of the interest cost paid to the bondholder, resulting in lower borrowing costs and cost of capital for infrastructure investments.

- **Green Tax Incentives.** The Ways and Means bill extends and modifies tax incentives for clean energy and energy-efficiency investments. "Base-level" incentives are pegged to the same amount (or in some cases, reduced) relative to current law. However, a "bonus rate" increases incentives amounts in the case of projects that comply with strict wage and workforce requirements, including prevailing wage standards and the use of qualified apprentices. The bill extends for 10 years the expiring tax credit for the construction of new energy-efficient homes. It extends the deduction for energy-efficient commercial buildings and creates an alternative test to incentivize "retrofits" of older commercial buildings that measures efficiency improvements relative to the building's baseline energy usage (rather than the most recent energy code). The bill creates a new, bonus 20% investment tax credit for solar energy property installed on affordable rental housing and extends for 10 years the expiring tax credit for electric vehicle charging stations. The bill creates an "elective pay" option for solar property, charging stations, CHP systems, energy storage, and certain other incentives, that can allow entities with minimal appetite for tax credits to request payments equal to the credit's value.

- **Estate Tax Valuation Discounts.** The Ways and Means bill eliminates transfer tax valuation discounts in the case of nonbusiness assets. Generally, nonbusiness assets are passive assets (including real property) that are held for the production of income and not used in the active conduct of a trade or business. The provision includes an exception for real property used in the active conduct of one or more real property trades or businesses if the transferor materially participates (i.e. provides 750 hours or more of services to the business). The provision applies to transfers after the date of enactment.

- **Application of Tax Rules to Grantor Trusts.** The Ways and Means bill includes a grantor trust in a decedent's taxable estate if the decedent is the deemed owner of the trust, thus preventing a taxpayer from controlling the trust while at the same time excluding the assets of the trust from the taxpayer's estate. The bill also treats sales between a grantor trust and its deemed owner as a sale between the owner and a third party. The changes would apply to trusts created on or after the date of enactment, and any portion of a trust attributable to a contribution made on or after the date of enactment.

- **Limitation on Deductibility of Active Losses.** The Ways and Means bill includes a provision modifying a change made in the *Tax Cuts and Jobs Act* that restricts taxpayers' ability to deduct active pass-through business losses against other types of income (portfolio income, passive income, and wages). The 2017 provision was drafted as a one-year deferral of the ability to use the loss against other income. The bill would permanently silo active losses so that they could only be used against active income.

- **REIT Constructive Ownership Rules.** Rents received by a REIT from a related party generally are not treated as qualified rental income for purposes of meeting REIT income requirements. Strict and mechanical rules apply to determine whether a tenant or an independent contractor is constructively related to a REIT. These rules can lead to unintended results when the tenant or contractor's economic relationship is indirect and several steps removed from the REIT. Often, the REIT itself may not even have good reason to be aware that an indirect ownership relationship exists. The Ways and Means bill modifies certain downward ownership attribution rules used to determine whether a REIT has a constructive ownership interest in a tenant or contractor.