The Real Estate Roundtable

AUGUST 2021 TOWN HALL

BUDGET RECONCILIATION: TAX PRIORITIES & TALKING POINTS

Like-Kind Exchanges

Congress should support healthy real estate markets and property values by preserving the current tax treatment of like-kind exchanges (section 1031 of the tax code).

- The President's budget would restrict gain deferred through real estate like-kind exchanges to no more than $500,000 per-year, or $1 million in the case of a married couple. The provision would be effective for exchanges completed in tax years beginning after 2021.
- Section 1031 is integral to the health of today's real estate marketplace: close to 20 percent of all commercial real estate transactions involve a like-kind exchange. Exchanges help get languishing properties into the hands of new owners who will invest in job-creating capital expenditures and improvements that put properties to their best and most productive uses.
- Exchanges helped stabilize property markets at the height of the COVID-19 lockdown and will facilitate a faster and smoother transition as many real estate assets are repurposed in the post-COVID economy.
- Like-kind exchanges allow businesses to grow organically, with less unsustainable debt, by reinvesting gains on a tax-deferred basis in new and productive assets. In this way, like-kind exchanges create a ladder of economic opportunity for minority-, veteran-, and women-owned businesses and cash-poor entrepreneurs that may lack access to traditional sources of financing.
- Academic and outside research has found that exchanges spur capital expenditures, increase investment, create jobs for skilled tradesmen and others, reduce unnecessary economic risk, lower rents, and support property values.
- Roughly 40 percent of like-kind exchanges involve rental housing. Section 1031 is an important source of capital for affordable and workforce housing. Like-kind exchanges help fill gaps in the financing of affordable housing that are unmet by the low-income housing tax credit (LIHTC). In contrast to LIHTC, developers can use section 1031 to finance land acquisition costs for new affordable housing projects.
- Like-kind exchanges provide critical financing to support economic development and investment in low-income, hard-hit, and distressed communities where outside sources of capital are less available. In addition, like-kind exchanges support vital public services (police, education, etc.) by boosting transfer, recording, and property tax revenue. Property taxes contribute nearly 3/4 of all local tax revenue.
- Land conservation organizations rely on exchanges to preserve open spaces for public use or environmental protection.

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Capital Gains

Congress should continue to encourage investment and job creation with a meaningful capital gains incentive.

- The President's budget would raise the top capital gains rate to parity with the top tax rate on ordinary income (currently 37%, but proposed to increase to 39.6%). The change would apply retroactively to transactions occurring after April 28, 2021. In addition, the President is proposing to extend the 3.8% tax on net investment income to the income of active business owners, including real estate professionals; the 3.8% tax applies to both capital gains and rental income. Senate Finance Committee Chairman Ron Wyden (D-OR) proposes to enact a mark-to-market regime for capital assets in which built-in gain is taxed on an annual basis, regardless of whether the asset is sold.
- Maintaining a reduced tax rate on capital gain decreases the cost of capital, drives long-term investment, encourages productive entrepreneurial activity, draws investment from around the world, and increases U.S. workforce productivity and competitiveness.
- We should be taking steps to encourage and reward risk-taking and investment in communities where it is needed, not punishing it.
- Opportunity Zones, which were created just a few years ago, have mobilized $85 billion in new investment in low-income communities. The entire premise of the Opportunity Zone idea is that those taking the risk will be rewarded with a lower capital gains tax.
- Our country's great cities are facing significant challenges. Many cities have an aging infrastructure that can only be fixed with a sustained infusion of capital investment. Public spending alone is not going to get us there. It is going to require partnering with the private sector and private capital. Raising taxes on capital income will make it harder to attract the private investment needed to rebuild our urban centers.
- Risk capital differs in meaningful ways from wage compensation. The entrepreneur who foregoes a traditional job in favor of starting a business and building a capital asset forfeits many protections and benefits offered to employees, most importantly the certainty of a pre-negotiated salary. The capital gains preference partially compensates entrepreneurs for bearing risk and uncertainty, including the potential of a complete loss on the investment of their time and capital.
- Relative to our peers, the United States levies a heavy tax burden on capital income. According to the Tax Foundation, 30 of the 36 developed countries in the OECD have a lower maximum tax rate on individual capital gain than the United States.
- In the case of real estate, the reduced tax rate on capital gain partially offsets the higher risk associated with illiquid, capital-intensive projects. It also helps compensate for the economic effects of inflation.

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Pass-Through Business Income

Congress should preserve the pass-through business income deduction, which reduces the tax burden on small business, closely held, and entrepreneurial businesses that create jobs and spur growth.

- Senate Finance Committee Chairman Ron Wyden (D-OR) has proposed repealing the 20% deduction for pass-through business income for taxpayers earning over $400,000/year.
- The pass-through deduction reduces the top tax rate on qualifying pass-through businesses from 37% to 29.6%. It applies to the rental and operating income of commercial real estate businesses. It also applies to ordinary REIT dividend income.
- The deduction was enacted in the Tax Cuts and Jobs Act to provide tax relief for the 30 million businesses that organized as sole proprietorships, partnerships, and S corporations and to avoid putting pass-through businesses at a competitive disadvantage relative to public corporations, which received a 40% reduction in their tax rate.
- Pass-through entities give owners flexibility in how they structure the risks and rewards of the business. Our pass-through regime is a strength of the U.S. tax system relative to our international competitors and contributes to our entrepreneurial culture and dynamic economy.

Step-Up in Basis and Taxation of Gains at Death

Congress should retain tax rules that allow family-owned and closely held businesses to continue from one generation to the next and avoid enacting new tax changes that result in the double taxation of real estate gains at death.

- The President's budget proposes to tax built-in gains at death unless the property is donated to charity. The proposal would apply to gains in excess of $1 million. In addition, the President proposes to tax the built, unrealized gains of property held in a trust or partnership if the property has not been taxed for 90 years (draft Senate legislation would reduce the term to 21 years for property held in trust).
- The tax code already taxes appreciated gains when someone dies. It is done through the estate tax. The estate tax has the same effect as taxing appreciated gains at death. When a person dies, the fair market value of his or her estate is determined, and if it is above the exemption amount ($5.85 million), then the 40% estate tax applies.
- It would be punitive and confiscatory to apply capital gains tax to appreciated property at the same time that the tax code is applying a 40% estate tax to the asset's full fair market value.
- Under the proposal, the taxpayer has not sold an asset and realized an actual gain, so there is no cash with which to pay the tax. Unlike a portfolio of publicly traded stock, a building is one asset and the proposal would effectively force the liquidation of real estate when it transfers from one generation to the next. Property owners should decide when it is the right time to sell, not the government.

Step-Up in Basis and Taxation of Gains at Death (Continued)

- Taxing capital gains at death would effectively pull long-term capital investment out of the economy at a time when it is most needed. Like many industries, commercial real estate has been hard hit by the pandemic. Buildings throughout the country will need to be reimagined, repurposed, and put to a new use. This is going to demand extraordinary amounts of new capital. Yet this proposal pulls capital out of private real estate markets just at the moment when we should be mobilizing capital and investment for future needs. The pass-through deduction reduces the top tax rate on qualifying pass-through businesses from 37% to 29.6%. It applies to the rental and operating income of commercial real estate businesses. It also applies to ordinary REIT dividend income.

Carried Interest

The tax code should continue to reward risk taking, and Congress should reject tax changes that limit capital gains treatment to invested cash.

- President Biden's budget, as well as the stand-alone Carried Interest Fairness Act (Rep. Bill Pascrell, D-NJ), would convert virtually all carried interest income attributable to gain from the sale of real estate to ordinary income subject to both ordinary income tax rates and self-employment taxes.
- The tax code should continue to reward risk taking and Congress should reject tax changes that limit capital gains treatment to invested cash. Proposed carried interest changes would harm small businesses and partnerships; stifle entrepreneurial risk taking and sweat equity; and threaten improvements and infrastructure in long-neglected neighborhoods most in need of investment.
- The false narrative surrounding the carried interest issue is that it targets only a handful of hedge fund billionaires and Wall Street executives. The carried interest legislation is far broader and would apply to real estate partnerships of all sizes—from two friends owning and leasing a townhome to a large private real estate fund with institutional investors.
- Much of the real estate investment that takes place today uses the partnership choice of entity. Real estate partnerships represent 50 percent of the nearly 4 million partnerships in the United States and include over 8 million partners.
- Carried interest is not compensation for services. General partners receive fees for routine services like leasing and property management. Those fees are taxed at ordinary tax rates.
- Carried interest is granted for the value the general partner adds to the venture beyond routine services, such as business acumen, experience, and relationships. It is also recognition of the risks the general partner takes with respect to the general partnership's liabilities. These risks can include funding predevelopment costs, guaranteeing construction budgets and financing, and exposure to potential litigation over countless possibilities.

Carried Interest (Continued)

- The Carried Interest Fairness Act would apply retroactively to transactions after December 31, 2020 – effectively raising taxes on sales that have already occurred.
- Moreover, the legislation would capture and apply to partnership agreements executed years—often decades—earlier. These negotiated agreements between the partners were based on well-established tax law as it existed at the time. By changing the tax results years later, the bill would undermine the predictability of the tax system and discourages the long-term, patient investment that moves our economy forward.
- In short, the Carried Interest Fairness Act would make it more expensive to build or improve real estate and infrastructure, including workforce housing, assisted living communities, and industrial properties, to name just a few. Some development simply won't happen, especially in long-neglected neighborhoods or on land with potential environmental contamination.

Energy Efficiency Tax Incentives

Congress should encourage a reduction in greenhouse gas emissions, reduce energy costs, and promote well-paying new jobs through expanded tax incentives for energy efficiency improvements in commercial buildings.

- Both the Senate Finance and House Ways and Means Committees are considering including green energy tax incentives in reconciliation legislation. The Senate Finance Committee recently passed the Clean Energy for America Act, which includes over $250 billion new incentives for renewable fuels, vehicles, electricity, and energy-efficient building improvements.
- The Roundtable has worked with Members of Congress from both parties to advance bipartisan legislation (E-QUIP Act, H.R. 2346) introduced by Representatives Brad Schneider (D-IL) and Tom Rice (R-SC). The legislation would provide accelerated depreciation for high performance, energy-efficient improvements to existing buildings.
- Over 80% of the commercial buildings standing in the United States were built prior to the year 2000 and before the advent of modern energy codes.
- Impactful energy and climate policy compels a focus on measures to modernize and retrofit America's aging commercial assets because they use a lot more energy and occupy a bigger carbon footprint compared to newer, more efficient construction.

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Affordable Housing

Congress should help expand and grow the supply of affordable and workforce housing by investing greater resources in time-tested tax incentives like the low-income housing tax credit.

- President Biden's budget dedicates $32 billion to the expansion of the low-income housing tax credit, a provision that helps subsidize the construction and rehabilitation of affordable housing.
- The President's proposed investment in additional LIHTC allocations represents more than a 30 percent increase over the current federal subsidy.