Tax Policy

COVID-19, Real Estate Tax Policy, and the Year Ahead

As the COVID-19 pandemic swept across the Nation in the spring and summer of 2020, policymakers appropriately looked to the tax code for ways to help individuals, families, and businesses survive government-mandated closures and a dramatic decline in economic activity. The Real Estate Roundtable contributed to those discussions by supporting aggressive legislative measures such as the *CARES* Act and recommending regulatory actions to provide relief to real estate owners, their tenants, and the overall economy.

Policymakers implemented several of The Roundtable's recommendations, including: changes that ensure partnerships are able to benefit from retroactive changes to cost recovery and loss carryback rules, and an extension of deadlines for completing like-kind exchanges. The pandemic is not yet behind us, and additional tax relief for struggling workers and businesses is needed to help the country build a bridge to a post-COVID environment in which Americans can once again live, work, and travel without the cloud of a public health crisis hanging over them.

Beyond the broad-based tax relief included in the *CARES* Act and the more recent end-of-year COVID legislation, The Roundtable urges policymakers to consider provisions such as tax changes to promote debt restructurings and workouts, tax relief for businesses that take proactive steps to create a safe and healthy workplace, and tax modifications that allow REITs to provide greater financial support to distressed tenants and the workers.

The year 2021 also marks the beginning of a new Presidential Administration and a new Congress. During the campaign, former Vice President Biden put forward numerous real estate-related tax proposals that would address critical needs, such as improving the supply and affordability of housing, incentivizing energy-efficient upgrades to buildings, and enhancing the effectiveness of Opportunity Zones. The Roundtable commends these efforts and intends to work closely with the incoming Administration to further develop and advance innovative, market-based tax policy solutions to issues such as housing availability, climate change, and access to capital.

At the same time, certain tax proposals put forward in the run-up to the election could have far-reaching negative and unintended consequences for real estate, job creation, and economic growth. For example, eliminating the reduced tax rate on capital gains or repealing the ability to defer capital gain through like-kind exchanges would reduce productive economic activity. As discussed in greater detail below, the long-standing tax rules related to capital formation play a critical role in stimulating investment, job creation, and the entrepreneurial risk-taking that contributes to a more dynamic and productive economy.

Rep. Stephanie Murphy (D-FL), a member of the House Ways and Means Committee, outlined efforts to work across the aisle by building a solutions-oriented approach to tax policy.

House Ways and Means Committee Chairman Richard Neal (D-MA) discusses various tax policies that would support sustainable economic growth and job creation.

A key element of The Roundtable's tax policy agenda involves continuing to develop and disseminate credible, fact-based analysis and research on how real estate-related tax provisions affect jobs, communities, and economic opportunity for all Americans.

Our core principles as they relate to tax policy remain unchanged. First, the tax code should ensure that tax rules closely reflect the economics of the underlying transaction and activity—avoiding either excessive marketplace incentives or disincentives that distort the flow of investment. Second, the tax system should facilitate capital formation (from domestic and foreign sources) and appropriate risk-taking, while also providing stable, predictable, and permanent rules conducive to long-term investment. Third, in limited and narrow situations (e.g., low-income housing and investment in economically challenged areas), tax incentives are necessary to address market failures and encourage capital to flow toward socially desirable projects. Fourth and lastly, any major changes should provide a well-designed transition regime that minimizes dislocation in real estate markets.

In short, the continued 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.

Specific issues on The Roundtable's tax policy agenda are described and discussed below.

Cancellation of Debt Tax Relief

In the hardest hit parts of the country, borrowers and lenders are actively working to defer or renegotiate debts to prevent bankruptcies and foreclosures. These actions can save businesses and preserve jobs. However, commercial real estate owners and other businesses need greater flexibility to work with their banks and other lenders to modify outstanding loans. The Treasury Department and the IRS have issued helpful new revenue procedures empowering lenders to modify loans held in trusts and mortgage-backed securities without triggering immediate tax liability for the lender. However, Congressional action is needed to provide help to the borrower struggling under the combined weight of large fixed expenses and steep declines in rental income. Current tax law discourages debt restructurings and workouts by subjecting borrowers to immediate income tax on discharged debt. In the case of COVID-19, Congress has already stepped in to provide relief for the $600 billion of Paycheck Protection Program (PPP) loans—any forgiveness of PPP loans is excluded from tax. Similar relief is needed for private loans. Congress should enact legislation in 2021 that defers tax on discharged debt by allowing taxpayers to exclude the income if they reduce the basis of their assets.

REIT Reforms

Within real estate, tenants in certain types of assets are particularly challenged. Some property owners organized as real estate investment trusts (REITs) would like to do more, on their own, to help provide a lifeline to struggling commercial tenants to preserve jobs. Specifically, they would like to lend and make equity investments in certain tenants to help them get through this difficult period. Overly mechanical related-party rules that apply to REITs prevent them from doing so. The bipartisan *Retail Revitalization* Act (H.R. 8805), introduced by Representatives Brad Schneider (D-IL) and Darin LaHood (R-IL), would help landlords keep retail businesses alive, and save jobs in the process, by modernizing the REIT related-party rule that taints rental income received by a REIT from a tenant with whom it has an equity or debt interest. The economic benefit of the change would greatly outweigh any minor, short-term impact on federal revenue.

Opportunity Zones

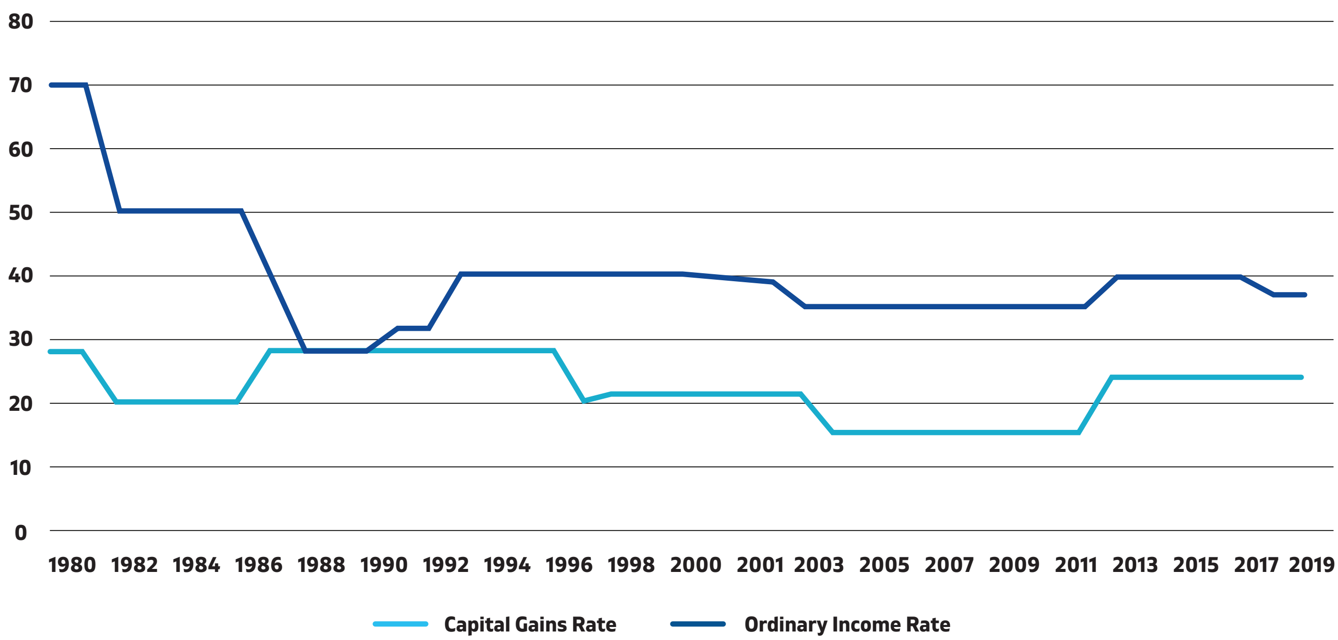
Congress created Opportunity Zones in the *Tax Cuts and Jobs* Act of 2017 to spur long-term capital investment and job creation in low-income, economically distressed communities. The tax benefits can include the deferral of tax on invested capital and the exclusion of capital gains tax on fund investments held for 10 years or more. The original legislation was developed by Senators Tim Scott (R-SC) and Cory Booker (D-NJ). Opportunity Zones have stimulated an estimated $52 billion in new investment, a large share of which consists of developing or rehabilitating multifamily housing and commercial real estate. The Real Estate Roundtable has played an active role in the OZ rule-making process, and has put forward several legislative recommendations designed to further enhance and improve the new incentives.

The Roundable recommendations include:

- Allowing opportunity funds to raise capital from all sources, not just gain rolled over from a recently disposed investment.
- Spurring productive real estate investment in low-income communities by providing that a 50 percent

Maximum Tax Rates on Capital Gains and Ordinary Income

For decades, Congress has encouraged productive investment and economic growth through a reduced tax rate on capital gains



Source: Dept. of Treasury, Office of Tax Analysis and Tax Policy Center. Capital gains rate from 2013 includes effect of 3.8% net investment income tax.

- increase in the basis of a building constitutes a substantial improvement of the property.
- Strengthening the economic incentives by codifying the tax rate on deferred gain and extending for two years the recognition date for deferred gain, and consequently, the deadlines that must be met in order to qualify for the increase in basis for gain rolled into an opportunity fund.

The Roundtable also supports the bipartisan efforts to improve OZ information reporting and transparency.

Low-Income Housing Tax Credit

The low-income housing tax credit (LIHTC) is the principal federal program financing the construction and rehabilitation of affordable housing. Tax incentives such as the LIHTC are a critical and necessary component of the multi-faceted strategy needed to make housing more accessible by removing constraints on the construction of new rental properties and the rehabilitation of existing properties. Legislation enacted at the end of 2020 included an important improvement to the reduced LIHTC credit available for the rehabilitation and redevelopment of existing housing. During the Presidential campaign, former Vice President proposed investing an additional $10 billion over ten years in improvements to the LIHTC. The Real Estate Roundtable supports measures such as the *Affordable Housing Credit Improvement* Act (S. 1703, H.R. 3077), which would increase the amount of low-income housing credits allocated to States by 50 percent and incentivize the building of more than 500,000 homes.

Capital Formation

Favorable tax rules for capital formation promote productive economic growth and job creation. For example, a low tax rate on capital income reduces the cost of capital; drives patient, long-term investment; and encourages productive entrepreneurial activity. In recent years, however, the tax burden on capital has increased relative to the tax burden on corporate income and ordinary wages. Legislation that would discourage capital formation further by raising the tax rate on capital gain is misguided. Similarly, policymakers should reject well-intentioned but detrimental proposals to reverse longstanding tax principles, such as the axiom that capital gain is deferred until an asset is actually sold. On the contrary, policymakers should take additional steps to encourage and reward productive investment through tax policies, such as Opportunity Zones, that mobilize long-term investment and support job growth and economic development.

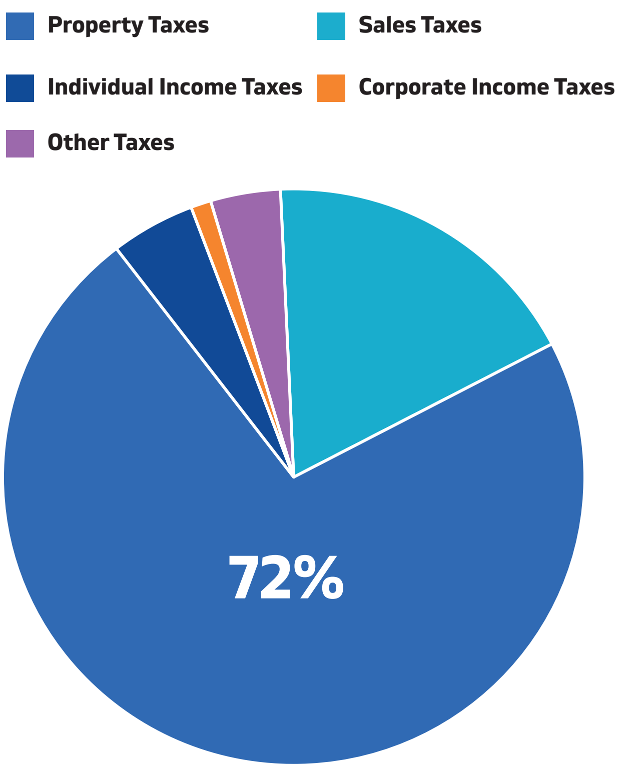
A low tax burden on capital can help attract investment from around the world, increase the productivity of the American workforce, and improve U.S. competitiveness. In the case of real estate investment, a reduced tax rate on capital gain can partially offset the higher risk associated with illiquid, capital-intensive projects and encourage capital to flow to entrepreneurial activities that improve communities. The reduced tax rate on capital gain also helps offset the burden associated with taxing uneconomic gain that is caused by inflation, as opposed to gain attributable to real asset appreciation. Relative to its 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.

Mark-to-Market Taxation of Capital Gain

Current proposals to tax capital gain on an annual, mark-to-market basis, if enacted, would move the tax code in a harmful direction. A mark-to-market tax system would defy the fundamental principle, enshrined since the 1920s, that income is taxed when it is realized, *i.e.*, when an asset is sold and its owner receives actual compensation for its appreciation in value. Taxing capital gain before it is realized would impose tax liability on nonexistent, phantom income and would create an administrative and tax compliance nightmare. More importantly, it would chill the long-term investment that drives economic progress.

Sources of Local Government Tax Revenue, United States

Taxes on real estate represent the largest source of local tax revenue: 72%



Source: U.S. Census Bureau, *2017 Census of Governments: Finance* (March 2020)

Efforts to moderate such proposals for assets like real estate by substituting a "lookback charge" for annual, mark-to-market taxation would still stifle productive investment by dramatically raising the overall tax burden on the asset.

Like-kind Exchanges

The ability to defer capital gain when a taxpayer exchanges one property for another is an essential feature of the current tax system that spurs capital investment, especially during times of market corrections and liquidity shortages. Like-kind exchanges help cash-poor entrepreneurs and investors, including minority-owned and women-owned businesses, grow organically.

New research by leading real estate academics, Dr. David Ling (Univ. Fla.) and Dr. Milena Petrova (Syracuse U.), demonstrate that like-kind exchanges are widely used by small businesses and small-scale property owners and investors, with the median section 1031 transaction involving a property valued less than $600,000. The Ling-Petrova study, commissioned by The Real Estate Roundtable and other real estate organizations, found that properties acquired in an exchange attract more net investment and capital expenditures, leading to job creation. Owners involved in exchanges tend to acquire modest multifamily rental properties, small shopping centers, and other income-producing assets.

In the current economic crisis, exchange-motivated buyers have helped stabilize real estate markets. Since exchanges are associated with shorter holding periods, they increase market liquidity. According to the Ling-Petrova study, property relinquished in a like-kind exchange has an average holding period that is almost one year shorter than the average holding period for property sold in a taxable sale (10.5 years vs. 11.4 years). Like-kind exchanges also eliminate the "lock in" effect on property ownership by eliminating the tax that would apply to built-in gain in a taxable sale.

Like-kind exchanges create a more dynamic real estate marketplace, ensuring properties do not languish, permanently underutilized and under-invested. Real property like-kind exchanges were preserved for real estate in the *Tax Cuts and Jobs Act* and should be retained in any future tax reform efforts.

Carried Interest

Carried interest arises when a partnership decides to allocate a share of its profits to one (or more) of the partners for reasons unrelated to the partner's initial capital contribution. Carried interest typically is granted for the value a general partner adds to a real estate or other 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 partnership's liabilities. These risks can include funding predevelopment costs, guaranteeing construction budgets and financing, and exposure to potential litigation over countless possibilities.

The Roundtable opposes efforts to tax all carried interest at ordinary income rates. Such changes would discourage risk-taking and reduce economic mobility by increasing the tax burden on cash-poor entrepreneurs who want to retain an ownership interest in their business. Proposed legislation would result in an enormous tax increase on countless Americans who use partnerships in businesses of all types and sizes. It would discourage individuals from pursuing their business vision, encourage debt rather than equity financing, tax sweat equity, and slow economic growth.

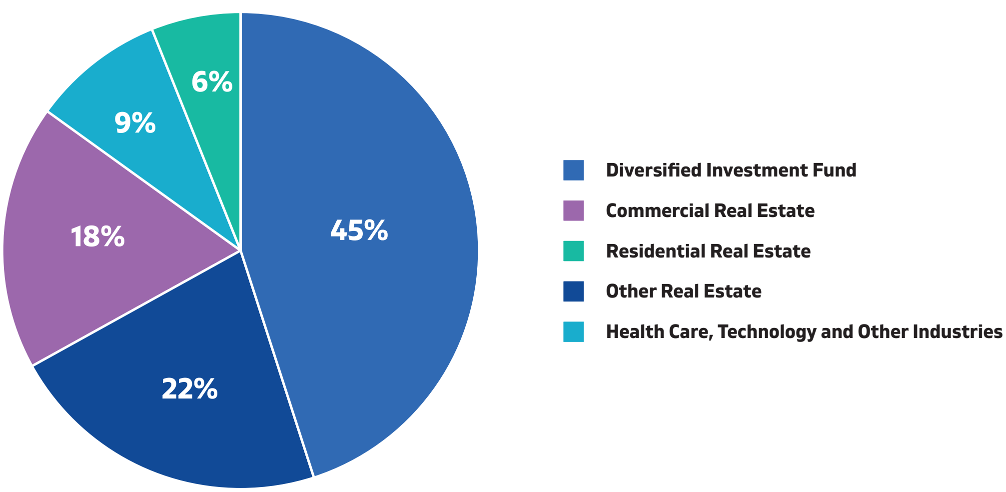
Foreign Investment

The *Foreign Investment in Real Property Tax Act of 1980 (FIRPTA)* imposes a discriminatory capital gains tax on foreign investors in U.S. real estate that does not apply to any other asset class. In so doing, the FIRPTA regime discourages capital formation and investment that could be used to create jobs and improve U.S. real estate and infrastructure.

FIRPTA applies to both real estate and infrastructure assets, which are treated as real property. As attention shifts toward infrastructure legislation and rebuilding our economy, Congress will likely consider measures designed to attract greater private investment. Policymakers should build on the reforms enacted in 2015, which repealed FIRPTA for investments made by foreign pension funds, and consider additional FIRPTA changes. These could include regulatory actions, such as the withdrawal of IRS Notice 2007-55, or legislative measures, such as the repeal of FIRPTA for infrastructure investments. A study by University of California-Berkeley professor Ken Rosen estimates that FIRPTA repeal would create 150,000–280,000 new construction-related jobs in the United States.

Principal Investment Focus of Opportunity Funds

Low-income communities are using Opportunity Zone tax benefits to attract real estate capital and create jobs



Source: White House Council of Economic Advisors. The Impact of Opportunity Zones: An Initial Assessment (Aug. 2020)