Taxing Unrealized Gains ("Billionaire Tax")

Issue

President Biden and key lawmakers such as Senate Finance Chairman Ron Wyden (D-OR), have proposed a mark-to-market regime in which built-in gain is taxed on an annual basis, regardless of whether the asset is sold. President Biden would impose a 25% minimum tax on the combined income and unrealized gains of taxpayers with $100 million in income or assets.

Taxpayers would report the total basis and estimated value of their assets on December 31 of each year. Tradable assets (e.g. public stock) would be valued using end-of-year market prices. Real estate and other less liquid assets would be valued at (a) the greater of original or adjusted cost basis, (b) the last valuation event from investment/borrowing/financial statements, or (c) other undefined methods.

Under the President's proposal, "illiquid" taxpayers, defined as taxpayers whose tradable assets make up less than 20% of their wealth, could pay the minimum tax only on their tradable assets, with a deferral charge of up to 10% when other gains are eventually realized.

Minimum tax payments would be treated as prepayments creditable against subsequent tax liability on realized capital gains. The tax in the first year would apply to prior, built-in gains and could be paid over a 9-year period. The tax in subsequent years could be paid over a 5-year period.

Efforts to include a mark-to-market regime in 2022 tax legislation were unsuccessful when they ran into resistance from moderate Congressional Democrats.

In *Moore v. United States*, the U.S. Supreme Court is reviewing a 2017 tax on unrepatriated foreign earnings and whether it violates any constitutional restrictions on the taxation of unrealized income. The decision could have implications for pending legislative proposals.

The Roundtable's Position

Taxing unrealized gains would upend over 100 years of federal taxation, require an unprecedented IRS intrusion into household finances, and create unknown and likely unintended consequences for the U.S. economy.

- At its core, the proposed tax on unrealized appreciation is a federal property tax that would apply year-in, year-out, regardless of whether one's property (real estate, stock holdings, paintings, jewelry, etc.) is generating any actual income, earnings, or profits for the taxpayer.

Taxing Unrealized Gains (“Billionaire Tax”)

- The tax would require the IRS to police households as they identify, tabulate, and value all their worldly possessions. The tax would thrust the IRS into a new and unwelcome role. The agency would become a permanent, live-in accountant and watchdog over every aspect of households' finances, consumer activity, and economic life.
- Tens of thousands of taxpayers will need to prove that their wealth falls below the relevant threshold ($100 million).
- Supporters of the tax want to extend it to an even larger number of taxpayers. Senator Wyden’s original proposal would have applied the tax to the unrealized gains of households with $1 million in income or $10 million in wealth.
- History suggests the tax would eventually apply to everyone. In 1913, the federal income tax applied to 1/3 of 1% of Americans. Ten years later, it applied to seven million Americans. Today, it applies to more than 150 million households.
- Revenue generated by the tax ($38 billion/year) is insufficient to make even a dent in the budget deficit ($1.5 trillion in 2022).
- Past attempts at wealth taxes in other countries have failed overwhelmingly because they were fraught with administrative problems, lacked public support, and had very little impact on income distribution. Of the 12 comprehensive wealth taxes that existed in the developed world in 1990, only three remain today.
- The tax will trigger wasteful disputes and litigation, detracting from productive economic activity. Annual valuation requirements will require costly appraisals. Valuation disagreements will be a constant source of audits and administrative appeals.
- Current law encourages taxpayers to put capital to work on projects that won't pay off for many years. By taxing business assets and investments annually, the tax will remove one of the major incentives for patient, productive capital investment. The differential tax treatment of liquid and illiquid investments will distort markets and give rise to wasteful new tax shelters and taxpayer games.
- The proposed tax is quite possibly unconstitutional. Supreme Court jurisprudence has applied a realization requirement to determine whether gains or profits constitute income taxable under the 16th Amendment. Since the proposed tax applies to both realized and unrealized gains, it may go beyond the boundaries of Congress’s taxing power.

Tax Policy

Capital Gains

Issue

Traditionally, the United States has taxed long-term capital gain at a lower rate than ordinary income. The only exception was a brief three-year period after the Tax Reform Act of 1986 when Congress lowered the top ordinary tax rate from 50% to 28% and created temporary tax parity between ordinary and capital income. Long-term capital gain is currently taxed at a top rate of 20%. However, the rate increases to 23.8% if the income is subject to the 3.8% tax on net investment income. The net investment income tax applies to real estate gains earned by passive investors and not income earned from the active conduct of professionals in real estate.

President Biden's budget proposes to raise the capital gains rate to 39.6%, which would bring it to parity with his proposed top rate on ordinary income. In addition, the president has proposed to increase the 3.8% tax on net investment income to 5% and extend it to the income of active business owners, including real estate professionals; the net investment income tax applies to both capital gains and rental income.

The Roundtable's Position

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

- 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.
- Policymakers should reward risk-taking and investment in communities where it is needed, not punish it.
- High taxes on capital income make it harder to attract the investment needed to rebuild our urban centers. Opportunity Zone capital gains incentives facilitated $75 billion in new investment in low-income communities in the first two years after enactment.
- Risk capital differs from wage compensation. The entrepreneur who foregoes a traditional job in favor of starting a business forfeits many protections and benefits offered to employees, such as a pre-negotiated salary. The capital gains preference compensates entrepreneurs for this risk, including the potential complete loss of their time and capital.
- The reduced capital gains rate partially offsets the higher risk with illiquid, capital-intensive real estate projects, as well as the economic effects of inflation.
- Unlike other tax policies, such as immediate expensing, the capital gains preference only rewards smart, productive investments that generate profits.

Pass-Through Business Income

Issue

Real estate generally is owned and operated through "pass-through" entities. In 2017, Congress reduced the corporate tax rate by 40% and created a new 20% deduction (section 199A) for pass-through business income to avoid putting partnerships, S corporations, and REITs at a competitive advantage relative to large C corporations.

Section 199A expires at the end of 2025. At that time, the effective marginal rate on pass-through business income would rise by over one-third, from 29.6% to 39.6%.

Tax legislation considered in 2021 would have raised the top marginal income tax rate on many small and pass-through business owners from 29.6% today to 46.4%.

Chairman Ron Wyden (D-OR) has proposed eliminating section 199A for pass-through owners with more than $500,000 in combined income.

The Roundtable's Position

Congress should continue to support closely-held, entrepreneurial businesses that create jobs and spur growth, and reject tax changes that discriminate against pass-through entities.

- Our pass-through regime is a competitive strength of the U.S. tax system. Most countries rely on inflexible corporate regimes that provide little ability for an entrepreneur to tailor the capital and ownership structure to meet the needs of the business and its investors.
- Small and closely-held businesses drive job growth and entrepreneurial activity in the United States. Entity choice is a differentiator that contributes to our entrepreneurial culture.
- Half of the 4 million partnerships in the U.S. are real estate partnerships, and real estate activity constitutes a large share of pass-through business activity.
- Listed REITs allow small investors to invest in diversified, commercial real estate using the same single tax system available to partners and partnerships.
- Partnerships, Limited Liability Companies (LLCs), S corps, and REITs are ideal for real estate because they give investors flexibility in how they structure the risks and rewards of these capital-intensive and relatively illiquid businesses.
- Any new tax legislation should avoid the unintended consequences and potential harm caused by the stacking of tax increases on pass-through entities.
- Section 199A is appropriately targeted at businesses that hire workers and invest in capital equipment and property.
- Section 199A also helps preserve tax fairness vis-à-vis large corporations.

Real Estate Like-Kind Exchanges

Issue

Since 1921, the tax code has allowed taxpayers to defer capital gain when exchanging real property used in a trade or business for a property of a like-kind (section 1031). In 2017, Congress narrowed section 1031 by disallowing its use for personal property (art, collectibles, etc.).

President Biden's budget would restrict gain deferred through like-kind exchanges to no more than $500K per year ($1M/couple).

The Roundtable's Position

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

- 15-20% of commercial transactions involve a like-kind exchange. Exchanges get languishing properties into the hands of new owners who improve them and put them to their best use.
- Like-kind exchanges helped stabilize property markets at the height of the COVID-19 lockdown. Exchanges are even more important during periods of market stress when external financing is harder to obtain. Section 1031 is facilitating a smoother transition as real estate assets are re-purposed in the post-COVID economy.
- Like-kind exchanges allow businesses to grow organically with less unsustainable debt, creating a ladder of economic opportunity for minority-, veteran-, and women-owned businesses and cash-poor entrepreneurs that lack access to traditional 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% of like-kind exchanges involve rental housing. Section 1031 helps fill gaps in the financing of affordable housing. Unlike the low-income housing tax credit, developers can use section 1031 to finance land acquisition costs for new affordable housing projects.
- Exchanges help low-income, hard-hit, and distressed communities where outside sources of capital are less available. Section 1031 also supports public services (police, education) by boosting transfer/recording/property taxes (nearly 3/4 of all local tax revenue).
- Land conservation organizations rely on exchanges to preserve open spaces for public use or environmental protection.
- Section 1031 is consistent with corporate and partnership tax rules that defer gains when the proceeds are retained and reinvested in businesses (sections 721, 731, 351, and 368).

Tax Policy

Carried Interest

Issue

A "carried" interest is the interest in partnership profits that a general partner receives from the investing partners for managing the investment and taking on the entrepreneurial risk of the venture. Carried interest may be taxed as ordinary income or capital gain depending on the character of the income generated by the partnership. Lawmakers have introduced various proposals to increase the tax burden on carried interest since 2007. In 2017, Congress created a three-year holding period requirement for the reduced long-term capital gains rate.

Legislation introduced by Rep. Bill Pascrell (D-NJ), the *Ending Wall Street Tax Giveaway Act* (H.R. 2686), would convert virtually all real estate-related carried interest income to ordinary income subject to the top tax rates and self-employment taxes.

In 2021, House Ways and Means Democrats passed legislation to extend the carried interest holding period from 3 to 5 years, and other changes, while adding a new exception for a real property trade or business (e.g., real estate). The proposals were not enacted.

Senate Finance Chairman Ron Wyden (D-OR) has proposed treating carried interest as an interest-free loan from the limited partners to the general partner that is taxable upon grant, regardless of whether the partnership ever generates any profits.

The Roundtable's Position

- The tax code should reward risk-taking; the capital gains rate should apply to more than just invested cash.
- Carried interest changes would harm small businesses, stifle entrepreneurs and sweat equity, and threaten future improvements and infrastructure in neglected areas. They would increase the cost of building or improving infrastructure, workforce housing, and assisted living, and deter risky projects, such as sites with potential environmental contamination.
- Carried interest is not compensation for services. General partners receive fees for routine services (leasing, property management). Those fees are taxed at ordinary tax rates.
- Carried interest is granted for the value the general partner adds beyond routine services, such as business acumen, experience, and relationships. It is also a recognition of the risks the general partner takes with respect to the general partnership's liabilities (funding pre-development costs, guaranteeing construction budgets, potential litigation).
- Carried interest proposals apply retroactively to prior transactions and partnership agreements executed years earlier. The agreements were based on tax law as it existed at the time. By changing the results years later, they would undermine the predictability of the tax system and discourage long-term, patient investment.

Tax Policy

Opportunity Zones

Issue

Created in 2017, Opportunity Zones (OZs) are designated, low-income census tracts where qualifying investments are eligible for reduced capital gains taxes. By channeling investment where it is needed, OZs help stimulate jobs and growth in low-income communities.

The three main OZ tax benefits are a deferral of prior capital gain rolled into an OZ fund, an increase (partial "step-up") in the basis of the prior investment after a 5 or 7-year holding period, and the exclusion of gain on the OZ investment 10 years.

The final OZ regulations were issued four months before the COVID lockdown. The tax benefits are gradually phasing down (the deferral of prior gain ends in 2026) and the partial basis step-up has expired for new OZ fund contributions.

Bipartisan House legislation (Reps. Mike Kelly, R-PA and Dan Kildee, D-MI; H.R. 5761) would extend OZ deadlines for two years, allow helpful "fund of funds" OZ tax structures, sunset certain high-income OZ census tracts, and create new OZ information reporting and transparency rules.

The Roundtable's Position

- In their short tenure, OZs have created jobs and spurred billions of dollars in new investment in economically struggling communities across the country.
- Opportunity Funds finance affordable, workforce, and senior housing; grocery-anchored retail centers; and commercial buildings that create spaces for new businesses and jobs.
- In 2020, the White House Council of Economic Advisors estimated that the Opportunity Funds had raised $75 billion in private capital in the first two years following the incentives' enactment, including $52 billion that otherwise would not have been raised. The council projected this capital could lift one million people out of poverty in OZs by 11%.
- The decentralized design of OZs allows more investors and stakeholders to participate in the market and invest in qualifying projects that generate economic opportunity and improve the built environment in high-need communities.
- Congress should pass H.R. 5761. Extending the deadlines would ensure that OZs continue to act as a catalyst for economic development in struggling communities.
- Congress should also continue working on improvements to the OZ tax incentives, such as enhanced information reporting, data collection, and transparency, as well as lowering the substantial improvement threshold to cover a broad range of real estate rehabilitation and redevelopment projects.

Tax Policy

Business Interest Deductibility

Issue

The 2017 tax bill included strict new limits on the deductibility of business interest but also included a key provision that allows commercial real estate (a real property trade or business) to opt out of the interest limitation.

The original House Republican tax plan—the House blueprint for tax reform—would have eliminated the deductibility of all business interest (including commercial real estate debt) while replacing depreciation rules with the immediate expensing of all future capital investment, including real property.

The final legislation included a revised section 163(j) in which the deductibility of business interest is generally limited to 30% of the taxpayer's EBITDA (earnings before interest, tax, depreciation, and amortization). It also included 100% expensing of equipment and machinery (not real estate) for 5 years, phasing down thereafter. The 30% interest limit does not apply to an electing real estate business. However, an electing real estate business is required to use the alternative depreciation system, which includes slightly longer cost recovery periods for real property and cannot immediately expense leasehold and other interior improvements. Since 2022, the general 30% business interest limitation has applied a less favorable rule that uses the taxpayer's EBIT (earnings before interest and tax) rather than EBITDA as the base for measuring the amount of deductible interest. Tax legislation passed by the House in early 2024 and supported by The Roundtable, the Tax Relief for American Families and Workers Act (H.R. 7024) would extend the EBITDA rule, which was in effect from 2018-2021, is one of the items at the center of current tax bill negotiations.

The Roundtable's Position

- Debt is a fundamental part of a real estate entity's capital structure and, in addition to property acquisition costs, is used to finance day-to-day operations and business activities like meeting payroll, buying raw materials, making capital expenditures, and building new facilities.
- New restrictions on interest deductibility would cause enormous damage to U.S. commercial real estate by dragging down property values and discouraging new investment. Fewer loans could be refinanced, fewer projects could be developed, and fewer jobs would be created.
- The ability to finance productive investment and entrepreneurial activity with borrowed capital has driven jobs and growth 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.

Tax Policy

Business Interest Deductibility

- Business interest expense is appropriately deducted under the basic principle that interest is an ordinary and necessary business expense. Interest income is taxable to the recipient.
- Commercial banks are the dominant source of financing for commercial real estate investment. Like other entrepreneurs, small and medium-sized real estate developers and investors lack access to equity markets and rely on traditional lending to grow and expand.