Tax Policy

Capital Gains

Issue

Traditionally, the United States has taxed long-term capital gains at a lower rate than ordinary income (wages, rent, and other compensation). 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 will increase to 23.8% if the income is subject to a 3.8% tax on net investment income. The net tax investment income applies to real estate gains earned by passive investors and not the income earned from the active conduct of professionals in real estate.

President Biden's Build Back Better agenda and his FY 2022 budget proposes to raise the capital gains rate to 39.6%, which brings it to parity with his proposed top rate on ordinary income. In addition, the President has proposed 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) has proposed 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.

The *Build Back Better Act* approved by the House Ways and Means Committee would have raised the capital gains rate from 20% to 25% and expanded the scope of the 3.8% net investment income tax, as proposed by the President. However, the version passed by the full House does not include an increase in the capital gains rate. The bill does include the expansion of the 3.8% income tax.

Talking Points

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

- Maintaining a reduced rate on capital gains 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 $75 billion in new investment in low-income communities. Investors in Opportunity Zones should be rewarded for their critical investments with lower capital taxes.
- 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.

Capital Gains

Talking Points (Continued)

- 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.

Pass-Through Business Income

Issue

Real estate generally is owned and operated through "pass-through" entities that allow income to pass through to individual owners rather than taxing the income at the entity level. In 2017, Congress reduced the corporate tax rate by 40% and also created a new 20% deduction (section 199A) for pass-through business income to avoid putting businesses organized as partnerships, S corporations (S corps), and Real Estate Investment Trusts (REITs) at a competitive advantage relative to large C corporations. Tax legislation proposed and considered in 2021 would significantly increase the combined tax rate on pass-through businesses. The version of the *Build Back Better (BBB) Act* that passed the House Ways and Means Committee would have raised the top marginal income tax rate on many small and pass-through business owners from 29.6% today to 46.4%. While the proposed tax increases on pass-through businesses were reduced prior to passage by the full House, significant challenges remain in the Senate. For example, Senate Finance Committee Chairman Ron Wyden (D-OR) has proposed eliminating section 199A for pass-through business owners with more than $500,000 in combined income.

Talking Points

Congress should continue to support small business, closely held, and entrepreneurial businesses that create jobs and spur growth by avoiding tax changes that discriminate against pass-through entities, such as partnerships and S corps.

- Our pass-through regime is a competitive strength of the U.S. tax system.
- Small and closely held businesses are the principal drivers of job growth and entrepreneurial activity in the United States. Entity choice is a differentiator that contributes to our entrepreneurial culture.
- Half of the country's four million partnerships are real estate partnerships. Real estate investment, new construction and development, and rental businesses constitute a significant share of pass-through business activity.
- 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 and partnerships.
- Pass-through entities, such as partnerships, Limited Liability Corporations (LLCs), and S corporations, as well as REITs, are ideal for real estate investment because they give investors flexibility in how they structure the risks and rewards of the business.
- The *Build Back Better Act* should avoid the unintended consequences and potential harm caused by the stacking of tax increases on pass-through entities which, when combined, would severely increase the tax burden on these job-creating businesses.
- Congress should preserve the 20% deduction for pass-through income (section 199A). The availability of the deduction is tied to hiring workers and investing in capital equipment and property.

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 property of a like kind. The *Tax Cuts and Jobs Act* of 2017 narrowed like-kind exchanges (section 1031) by disallowing their use in the case of personal property (art, collectibles, etc.) As part of his Build Back Better agenda, President Biden has proposed restricting 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 President's proposal would be effective for exchanges completed in tax years beginning after 2021. The *Build Back Better Act* approved by the House does not include new restrictions on like-kind exchanges.

Talking Points

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

- Section 1031 is integral to the health of today's real estate marketplace: close to 20% 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% 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.

Carried Interest

Issue

A "carried" interest is the interest in partnership profits 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 change the tax treatment of carried interest since 2007. In the *Tax Cuts and Jobs Act of 2017*, Congress created a three-year holding period requirement in order for carried interest to qualify for the reduced long-term capital gains rate.

In the current Congress, the *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.

President Biden's Build Back Better agenda calls on Congress to "close the carried interest loophole so that the hedge fund partners will pay ordinary income rates on their income just like every other worker."

The version of the *Build back Better Act* approved by the House Ways and Means Committee would have extended the current holding period required for carried interest to qualify for long-term capital gains treatment from 3 years to 5 years. However, the extension of the holding period would include an important new exception for a real property trade or business (*e.g.,* real estate). Other aspects of the House proposal would indirectly extend the required holding period by not starting the clock until substantially all assets have been acquired by the partnership. The Ways and Means changes to carried interest were dropped from the bill before its passage by the full House.

In the Senate, legislation proposed by Finance Committee Chairman Ron Wyden (D-OR) would treat 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. Key Senate centrist Joe Manchin (D-WV) has expressed support for ending capital gains treatment for carried interest.

Talking Points

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

- Much of the real estate investment that takes place today uses the partnership choice of entity. Real estate partnerships represent 50% of the nearly 4 million partnerships in the United States and include over 8 million partners.
- 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.
- Carried interest is not compensation for services. General partners receive fees for routine services such as leasing and property management. Those fees are taxed at ordinary tax rates.

Carried Interest

Talking Points (Continued)

- 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 pre-development costs, guaranteeing construction budgets and financing, and exposure to potential litigation over countless possibilities.
- Some carried interest proposals would apply retroactively to prior transactions - effectively raising taxes on sales that have already occured.
- 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 discourage the long-term, patient investment that moves our economy forward.
- In short, these proposals 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.

Affordable Housing

Issue

The United States is facing a severe shortage of affordable housing. There are a number of complex factors contributing to the lack of sufficient housing supply, and many of these factors relate to policies at the state and local level. However, one federal policy tool that has proven effective in stimulating new, affordable housing is the LIHTC. Since its inception in 1986, LIHTC has financed the development of nearly 3.5 million affordable rental homes that house over 8 million low-income households.

President Biden's Build Back Better agenda and FY 2022 budget would dedicate $32 billion to the expansion of LIHTC. The President's proposed investment in additional LIHTC allocations represents more than a 30% increase over the current federal subsidy.

The *Build Back Better Act* approved by the House Ways and Means Committee would have provided $29 billion over 10 years to expand LIHTC, including a 50% increase in the allocation of credits to states. As the cost of the overall bill came down during negotiations, the LIHTC expansion was scaled back from $29 billion to $12 billion.

Talking Points

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.

- More than 10 million low-income households spend more than half of their monthly income on rent, according to Harvard's Joint Center for Housing Studies.
- LIHTC is an efficient, market-based housing solution that relies on the private sector to finance, build, and operate affordable housing by creating a federal incentive for new construction and redevelopment.
- Under the successful LIHTC program, states can award housing credits based on their own affordable housing priorities. They can target credits to housing units dedicated to certain populations such as seniors or veterans, or to specific regions most in need of affordable housing.
- The *Tax Cuts and Jobs Act* of 2017 indirectly diminished the value of low-income housing credits because the corporate tax cut reduced the underlying tax liability of many tax credit purchasers, thereby decreasing demand for the credits in the marketplace.
- Congress should significantly expand LIHTC, along the lines of the *Affordable Housing Credit Improvements Act* (S.1136, H.R. 2573), which would create and preserve more than 2 million affordable homes, support 3 million jobs, and generate $119 billion in sustainable tax revenue.