Tax Policy

Taxing Unrealized Gains ("Billionaire Tax")

Issue

President Biden and certain key lawmakers, including Senate Finance Committee Chairman Ron Wyden (D-OR), have 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. President Biden's proposal would impose a minimum 25% 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 elect to pay the minimum tax only on their tradable assets, with a deferral charge of up to 10% when gains on non-tradable assets 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.

In the last Congress, efforts to include a version of the mark-to-market regime in tax reconciliation legislation were unsuccessful when they ran into resistance from moderate Congressional Democrats.

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 Roundtable's Position (Continued)

- 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, disagreements, and administrative appeals with tax collectors.
- The potential unintended and unknown consequences of taxing unrealized gains are immense. The longstanding principle that taxes are deferred until a gain is realized 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.

Taxing Unrealized Gains ("Billionaire Tax")

The Roundtable's Position (Continued)

- Charities, educational endowments, and churches will suffer. The ability to contribute appreciated assets to public charities and other nonprofits without owing tax on the unrealized gain provides an important economic inducement for philanthropic giving. Taxing unrealized gains on an annual basis will eliminate this economic incentive.
- 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.

Capital Gains

Issue

Traditionally, the United States has taxed long-term capital gain 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 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.

A proposed increase in the capital gains tax rate and an expansion of the 3.8% tax on net investment income were dropped from tax reconciliation legislation in the last Congress at the insistence of Congressional moderates, particularly Sen. Kyrsten Sinema (D-AZ).

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 be taking steps to encourage and reward risk-taking and investment in communities where it is needed, not punishing it.
- Capital gains tax incentives are effective in mobilizing capital. Opportunity Zones, which offer the potential to exempt capital gains from tax altogether, facilitated $75 billion in new investment in low-income communities in just their first two years after enactment.

The Roundtable's Position (Continued)

- 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.
- Unlike other tax policies, such as immediate expensing, the capital gains preference only rewards smart, productive investments that are economically profitable on their own, irrespective of the tax incentive.

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 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 (C corps).

Tax legislation proposed and considered in the last Congress would have significantly increased 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 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%.

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.

Largely at the insistence of Congressional Democratic moderates, particularly Sen. Kyrsten Sinema, tax reconciliation legislation enacted in the last Congress did not include any changes to the general tax rate on pass-through businesses or new restrictions on the 199A deduction

The Roundtable's Position

Congress should continue to support small, 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. Most other developed countries are heavily reliant 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.
- 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.

Pass-Through Business Income

The Roundtable's Position (Continued)

- 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), S corps, and REITs, are ideal for real estate investment because they give investors flexibility in how they structure the risks and rewards of the business. The benefits of pass-through taxation help compensate real estate owners for the additional risks and challenges associated with the ownership of large, capital-intensive, and relatively illiquid assets.
- Any new tax legislation 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 a 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.).

President Biden proposes to severely limit real estate like-kind exchanges. 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 president's proposal would be effective for exchanges completed in tax years beginning after 2023.

The Roundtable's Position

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 re-purposed 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 as well as 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.

Real Estate Like-Kind Exchanges

The Roundtable's Position (Continued)

- 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 (i.e. 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.
- The ability to defer gain on a like-kind exchange is very consistent with a general policy in U.S. taxation that business-related gains are deferred provided the proceeds are retained and reinvested in the business. The deferral of gain in partnership (sections 721 and 731) and corporate (sections 351 and 368) transactions is allowed even when the proceeds are invested in property that is different from the property that generated the gain.

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 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 last Congress, the *Carried Interest Fairness Act* (Representative Bill Pascrell, D-NJ) would have converted 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 has proposed 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."

Legislation approved by the House Ways and Means Committee in the last Congress would have extended the current holding period required for carried interest to qualify for long-term capital gains treatment from three years to five years. Fortunately, 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 all assets have been acquired by the partnership. However, the carried interest proposals were dropped from the bill before its passage by the full House.

In the Senate, Finance Committee 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 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 four million partnerships in the United States and include over eight million partners.

The Roundtable's Position (Continued)

- 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 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 a 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 occurred.
- Moreover, the legislation would capture and apply to partnership agreements that were 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.

Opportunity Zones

Issue

Created in the Tax Cuts and Jobs Act of 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 most needed and prioritized by states and local communities, OZs help stimulate job creation and economic growth in low-income communities.

Capital gain from prior investments—proceeds from the sale of real estate, stocks, securities, etc.— can be rolled into an Opportunity Fund and the tax that would otherwise be owed on the gain from the prior investment is deferred and not taxed until the end of 2026. Second, capital gains tax on this deferred gain is reduced by 10% if the investment is held for five years or 15% if the investment is held for seven years (through a tax basis "step-up"). Third, capital gain generated from the investments made by the Opportunity Fund is exempt from capital gains tax altogether if the investment in the fund is held for at least 10 years.

Unfortunately, delays in the rulemaking process and the onset of the COVID-19 pandemic have short- circuited the full impact of OZs. The final OZ regulations were issued just four months (December 2019) before COVID-19 caused a national economic lockdown that severely affected taxpayers' ability to launch new real estate projects and other businesses.

In addition, the tax benefits associated with OZ investments are gradually phasing down and a significant OZ tax incentive expired at the end of 2021. Investors no longer qualify for the 15% basis step-up that applies to prior gain if the investment is maintained for at least seven years. Separately, the economic value of the temporary tax deferral that applies to gain rolled into an Opportunity Fund is gradually declining as 2026 draws near.

In the last Congress, bipartisan, bicameral legislation (S. 4065 / H.R.7467) introduced by Senators Cory Booker (D-NJ) and Tim Scott (R-SC) and Representative Ron Kind (D-WI) and Mike Kelly (R-PA) in the 117th Congress would have extended the OZ deadlines by two years and make other important OZ reforms. The reforms include sunsetting the eligibility of certain high-income OZ census tracts for future investments, mandating new OZ information reporting rules, and creating a new fund for localities to support businesses and projects in OZs.

The Roundtable's Position

- In the short time since their enactment, OZs have created jobs and spurred billions of dollars in new investment in economically struggling communities across the country.

Opportunity Zones

The Roundtable's Position (Continued)

- Opportunity Funds have financed affordable, workforce, and senior housing, grocery-anchored retail centers, and office buildings that allow new and growing businesses to gain a presence and create jobs in long-neglected neighborhoods.
- Other examples of productive activities in OZs include the rehabilitation of dilapidated buildings into new hotels that boost local tax revenue and serve as a magnet for jobs, visitors, and economic activity in the surrounding area.
- OZs have demonstrated extraordinary potential to improve communities. In 2020, the 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%.
- Most recently, the GAO estimated that 6,000 Opportunity Funds with more than 18,000 partners or shareholders invested $29 billion in OZs in 2019 alone.
- 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 act quickly to extend expired OZ deadlines, as proposed in S. 4065 / H.R.7467. Extending the deadlines would ensure that OZs continue to act as a catalyst for economic development in struggling communities and allow the program to fulfill its original promise.
- 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.

Inflation Reduction Act Revenue Provisions: Fact Sheet

Issue

The *Inflation Reduction Act of 2022* (IRA) was signed into law by President Biden on August 16, 2022. The legislation was paid for through various provisions including adjustments to corporate taxes as well as a new stock buyback excise tax. The real estate industry encouraged lawmakers to drop proposed changes to carried interest rules that were part of the initial agreement between Senators Joe Manchin (D-WV) and Chuck Schumer (D-NY). The tax increases on carried interest were not included in the final legislation. The changes would have slowed housing production, discouraged the capital needed to reimagine buildings to meet post-pandemic business needs, and hampered job creation while creating an additional unknown in an already challenging economic environment.

The Roundtable will continue advocating for tax policies that facilitate capital formation, reward risk-taking, and bolster productive private investment. Below is our summary of key IRA revenue-raising provisions.

Corporate Book-Income Alternative Minimum Tax

The bill creates a new 15% corporate alternative minimum tax that applies when minimum tax liability exceeds regular tax liability, applicable for tax years beginning after December 31, 2022. The minimum tax has a lower rate—15% compared to the 21% corp. tax rate—but a broader base that reflects public accounting rules (GAAP or IFRS) rather than tax accounting rules. The base begins with financial statement income (book income) and includes certain adjustments. The tax applies to corporations with average annual book income, over a 3-year period, exceeding $1 billion.

REITs, S Corps, and RICs are exempt from the tax. For purposes of determining if a corporation is covered by the tax, a corporation's book income is aggregated with the income of all persons treated as a single employer under sections 52(a) or 52(b). However, a Senate floor amendment offered by Senators John Thune (R-ND) and Kyrsten Sinema (D-AZ) modified the aggregation rules to clarify that section 212 activities for the production or collection of income do not constitute a trade or business activity that requires aggregation under section 52. This amendment restricts the need to aggregate distinct portfolio companies that are owned under a private equity or other fund structure.

Inflation Reduction Act Revenue Provisions: Fact Sheet

Corporate Book-Income Alternative Minimum Tax (Continue)

Certain adjustments are made in measuring book income. Perhaps most importantly for real estate, tax depreciation deductions (e.g., accelerated depreciation and immediate expensing) are permitted for purposes of calculating book income. Book income is also reduced to reflect financial statement net operating loss carryovers.

The new minimum tax allows taxpayers to claim the low-income housing tax credit (LIHTC), new markets tax credit (NMTC), and other section 38 business credits to the same extent as allowed under the regular corporate income tax, ensuring no negative impact on the low-income housing incentive. This provision permits financial institutions and other large taxpayers to continue investing in affordable housing without generating new minimum tax liability.

Pass-Through Active Loss Limitation

The bill extends for two years a limitation on the deductibility of active pass-through business losses against other income. While the tax code has restricted the ability of taxpayers to deduct passive losses against other income since the 1980s, the Tax Cuts and Jobs Act of 2017, for the first time, included new general limits on a taxpayer's ability to deduct losses from an active business activity against other income, wage, and portfolio (investment) income. The limit applies to net, aggregate losses in excess of $250K for an individual and $500K for a married couple. The IRA extended the limitation (section 461(l)) for two years, through 2028. The extension of the active loss limitation was added on the Senate floor in an amendment offered by Sen. Mark Warner (D-VA) to replace another revenue provision that would have extended the limitation on the deductibility of state and local taxes by one year, through 2026.

Stock Buyback Excise Tax

The bill imposes a nondeductible 1% excise tax on the value of stock that is repurchased during the tax year by a publicly traded U.S. corporation or its affiliate. The excise tax does not apply to repurchases by a REIT or a RIC, or if the repurchase is part of a tax-free reorganization. The provision applies to repurchases of stock after December 31, 2022.

Tax Policy

Inflation Reduction Act Revenue Provisions: Fact Sheet

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