The Real Estate Roundtable

April 7, 2017

The Honorable Steven T. Mnuchin
Secretary of the Treasury
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Secretary Mnuchin:

The Real Estate Roundtable shares the Administration's commitment to creating jobs, lifting wages, and increasing prosperity and economic opportunity for all Americans. Our organization brings together leaders of the nation's top real estate ownership, development, lending, and management firms to address key national policy issues relating to real estate and the overall economy. We welcome the focus that the President and you have brought to the often-unintended consequences of federal regulations and write to share our views on certain areas where your executive actions as Secretary of the Treasury could help drive job creation and modernization of U.S. real estate and infrastructure.

Smart reforms that simplify unnecessarily complex tax rules, reduce uncertainty for businesses, and remove or revise old regulations that have outlived their usefulness could spur productive real estate and infrastructure investment and accelerate job growth. As you noted in your testimony before the Senate Finance Committee, "[s]ensible regulation is a necessity for healthy markets." Tax regulations, in particular, merit close review and attention because of their potential to distort the economics of private sector business decisions.

Moreover, these administrative efforts will produce tangible economic benefits in a fiscally responsible manner, without any new federal spending. Specifically, we recommend the following regulatory actions to promote growth in real estate commerce, infrastructure, and related jobs:

- **Mobilize capital and stimulate increased investment in U.S. real estate and infrastructure by repealing IRS Notice 2007-55 and clarifying recent FIRPTA reforms**. Today, the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) deprives the United States of billions of dollars of global capital that could be directed towards U.S. commercial real estate and infrastructure improvements. The law imposes a much higher tax burden on inbound investment in U.S. real property relative to other types of U.S. assets, such as stocks and bonds. FIRPTA can result in a tax burden as high as 54.5 percent on the investor's gain when the U.S. real property is sold. In 2007, outside the normal "notice and comment" regulatory process, the IRS reversed its prior position and advised taxpayers that a liquidating distribution from a domestically controlled real estate investment trust (REIT) to a foreign shareholder is subject to tax under FIRPTA. IRS Notice 2007-55 had a chilling effect on foreign investment in U.S. real estate. Over 50 Members of the congressional tax-writing committees have supported its repeal. In 2015, Congress made significant progress in providing relief from FIRPTA for certain types of investments, but the Notice remains in place. IRS Notice 2007-55 should be repealed.

In addition, Treasury should issue additional guidance clarifying the broad scope and application of the FIRPTA reforms enacted in the *Protecting Americans from Tax Hikes (PATH) Act of 2015*. The *PATH Act* included a series of changes intended to reduce the burden of FIRPTA and spur job-creating real estate and infrastructure investment in the United States. The legislation created a new exemption from the application of FIRPTA for investment by foreign pension funds, a large and growing source of capital in the global economy. In partnership with American firms, foreign pension funds can serve as critical sources of equity investment to help finance U.S. real estate and infrastructure projects that create jobs and strengthen communities. Some pension arrangements, however, have struggled with the lack of Treasury guidance on the *PATH Act's* definition of a qualified foreign pension fund. Although they serve the same underlying function as U.S. pension funds, the structure and design of foreign pension arrangements often differ from the U.S. pension model. The uncertainty associated with the manner in which Treasury will interpret the FIRPTA reforms in the *PATH Act* is tempering the intended benefits of the law and frustrating inbound investment into U.S. real estate. *By repealing the Notice and issuing FIRPTA guidance that is consistent with the legislative intent of* the PATH Act, *the Administration would unlock significant foreign capital, stimulate real estate commerce and inbound investment, and create jobs aimed at improving and upgrading U.S. real estate and infrastructure*.

- **Encourage much-needed residential housing by modifying tax rules under section 460(e) that create "phantom income" for new condominium construction.** Major condominium developments regularly take two or three years to complete, or even longer. In these cases, the developer often will market units to the public prior to completion and accept deposits from prospective buyers in order to secure construction financing. The developer does not receive the balance of the purchase price or generally have access to the original deposit until the condominium unit is delivered and the buyer closes on the purchase. Existing tax accounting rules, however, impose immediate tax on these "pre-sales," creating a mismatch of cash flow and unjustly accelerating tax liability on condominium construction. This punitive and discriminatory tax treatment does not apply to the construction of townhouses, rowhouses, and condominium buildings with four or fewer units. Left unchanged, the rules threaten new housing production, job growth, and economic activity. Regulations proposed in 2008 would solve this problem by allowing new condominium construction to qualify for the completed contract method of accounting, but they have not been finalized. *By finalizing the proposed regulations, the Administration would help residential housing projects move forward that create construction and related jobs for Americans*.

- **Spur capital formation by removing unnecessary roadblocks to institutional investment in real estate funds.** Under IRS Private Letter Ruling 201444022, a real estate investment fund that employs a REIT structure with two different classes of shares in order to differentiate management and advisory fees (based on the size of the investment) violates the statutory prohibition against preferential REIT dividends. The ruling discourages the formation of new real estate investment funds that rely heavily on institutional investors for capital. In effect, it makes it more difficult for pension funds, life insurance companies, and others that manage the savings of workers and retirees to invest in real estate and infrastructure. Beyond the ruling, as part of the *PATH Act*, Treasury and the IRS were given explicit authority to provide alternative remedies to disqualification of a dividends paid deduction for dividends that are determined to be preferential. *By repealing the IRS ruling, the Administration would remove an unnecessary barrier to investment in job-creating real estate and infrastructure projects. In addition, Treasury should issue guidance providing relief from the burdensome and excessive penalty—often the disqualification of an entity as a REIT—that currently is imposed with respect to preferential dividends.*

- **Repeal recently finalized and proposed regulations affecting real estate partnership structures.** Newly issued partnership liability allocation regulations under section 752 will greatly restrict the ability of individuals to pool their capital, property, and expertise for productive real estate activities. The partnership liability allocation rules have important implications for the movement of real estate in common partnership contribution transactions, whether involving a single property or a portfolio of properties in roll-up transactions and REIT transactions using umbrella partnership (UPREIT) structures. Today, UPREIT structures and partnership roll-up transactions allow individual property owners to diversify their investments and obtain greater liquidity and transparency with respect to their property ownership interests in a tax-deferred transaction akin to a tax-deferred corporate reorganization. Liability guarantees are widely used in connection with these transactions in order to match the allocation of partnership liabilities with the partner with risk of loss with respect to the liability and to preserve the deferral of capital gain. Legitimate guarantees allow a partner to accept a risk of economic loss and obtain basis that can be used to deduct allocated losses. Under newly issued regulations under section 752, many guarantees, including bottom dollar guarantees, no longer are recognized for tax purposes. *By withdrawing the final and proposed regulations, the Administration could ensure that any new rules do not discourage capital formation, job creation, and economic activity.*

- **Promote new investment and economic activity by reducing barriers that discourage real estate partnerships between taxable and tax-exempt investors.** The "fractions rule" embodies a complex set of rules intended to address allocations in connection with partnerships between certain tax-exempt and taxable partners in the context of debt-financed property. These rules long have been criticized for their broad reach and unintended consequences for legitimate commercial transactions. In November 2016, Treasury and the IRS issued proposed regulations that would amend the current regulations to provide more reasonable results in a number of common commercial arrangements. While a good start, those proposed regulations drew narrow lines in a number of contexts that make the "fixes" largely unhelpful. *The Administration could significantly encourage capital formation from tax-exempt entities by finalizing the proposed "fractions rule" regulations and following more closely the technical comments that have been made with respect to such rules. These changes would promote jobs and growth by increasing investment in real estate by pension plans and endowments.*

- **Modify proposed regulations that could potentially limit a REIT from spinning off another REIT on a tax-deferred basis**. Proposed regulations issued in October 2016 aimed generally at stopping spin-offs under section 355 are overbroad and could unintentionally prevent a REIT from distributing one of its real estate businesses as another REIT even though both businesses are taxed at the shareholder level both before and after a spin-off. It is clear that Congress intended that REIT to REIT spin-off transactions be allowed. Certain provisions contained in these proposed regulations should be modified or made inapplicable to REIT to REIT spin-off transactions in order to follow congressional intent. *By modifying these regulations, the Administration would continue to allow REITs to provide diversification to all investors without unnecessary and unwelcome restrictions.*

- **Harmonize overlapping partnership loss limitation regimes.** Three separate sets of rules, each complex in its own right, limit partners' ability to deduct losses from a partnership: (1) at-risk rules under section 465; (2) partnership allocation, tax basis determination, and loss limitation rules under sections 704 and 752; and (3) passive activity loss rules under section 469. These three regimes essentially all seek to limit the deductibility of losses to the taxpayer's investment exposure to the business, including some measure of his or her share of borrowed capital, but each regime has rules materially different from the others. Their interaction leads to unnecessary complexity, business uncertainty, and misapplication of the rules by taxpayers and revenue agents alike. Largely due to this complexity, enforcement and compliance is limited. *As part of its comprehensive, regulatory review process, the Treasury Department should consider ways to consolidate and simplify these largely overlapping regimes. For example, while legislation may be needed, the Administration could work with Congress to reduce taxpayer confusion and eliminate a source of uncertainty by repealing the at-risk rules of section 465 altogether, which are artificial impediments to real estate commerce.*

Well-designed tax guidance can affirmatively help taxpayers and promote economic activity by providing needed clarity regarding the meaning of statutory provisions. For example, the *Bipartisan Budget Act of 2015* overhauled the tax rules for auditing partnerships. The new partnership audit regime represents the most significant change to tax administration in more than 20 years. The new rules take full effect in 2018, and interpretive regulations from Treasury are critical to facilitate the transition to the new statutory audit regime for the country's two million real estate partnerships. For these reasons, tax guidance should be treated differently than other types of regulatory activity—it is not appropriate or desirable always to require the repeal of two tax regulations anytime new tax guidance is issued.

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. Taken together, the regulatory changes recommended above would have an enormous impact on capital formation—stimulating investment here at home in real estate projects and activities that create well-paying jobs and strengthening the broader economy. These actions will complement the President's effort to reform the tax system and support your stated goal to "get the engine of economic growth firing on all cylinders once again."

We appreciate your consideration of these recommendations and look forward to working with you, cooperatively, in the weeks and months ahead.

Sincerely,

Jeffrey D. DeBoer
President and CEO