

Statement for the Record

**Hearing on FY 2018 Budget Proposals for the Department of Treasury and Tax Reform**

Committee on Finance  
U.S. Senate

June 1, 2017

As the Senate Committee on Finance meets to consider budget and tax priorities with the Secretary of the Treasury, the 21 undersigned national real estate organizations appreciate the opportunity to share our views on tax reform and commercial real estate. While the comments below broadly represent the views and perspective of the real estate industry, individual property types or investment structures may have unique tax issues and policy concerns more appropriately addressed in separate communications.

**OVERVIEW**

Real estate is deeply interwoven in the U.S. economy and the American experience, touching every life, every day. Millions of Americans share in the ownership of the nation's real estate, and it is a major contributor to U.S. economic growth and prosperity. Real estate plays a central role in broad-based wealth creation and savings for investors large and small, from homeowners to retirees invested in real estate via their pension plans.

Commercial real estate provides the evolving physical spaces in which Americans work, shop, learn, live, pray, play, and heal. From retail centers to assisted living facilities, from multifamily housing to industrial property, transformations are underway in the "built environment." Investment in upgrading and improving U.S. commercial real estate is enhancing workplace productivity and improving the quality of life in our communities.

Among its vast economic contributions, the real estate industry is one of the leading job creators in the United States, employing over 13 million Americans—more than one in every 10 full-time U.S. workers—in a wide range of well-paying jobs. Real estate companies are engaged in a broad array of activities and services. This includes jobs in construction, planning, architecture, building maintenance, management, environmental consulting, leasing, brokerage, mortgage lending, accounting and legal services, agriculture, investment advising, interior design and more.

Commercial real estate encompasses many property types, from office buildings, warehouses, retail centers and regional shopping malls, to industrial properties, hotels, convenience stores, multifamily communities, medical centers, senior living facilities, gas stations, land and more. Conservatively estimated, the total value of U.S. commercial real estate in 2016 was between \$13.4 and \$15 trillion, a level that matches the market cap of domestic companies on the New York Stock Exchange. Investor-owned commercial properties account for about 90 percent of the total value, with the remainder being owner-occupied. Based on the latest data available from the Federal Reserve, U.S.

commercial real estate is leveraged conservatively with about \$4.2 trillion of commercial real estate debt.

Industry activity accounts for nearly one-quarter of taxes collected at all levels of government (this includes income, property and sales taxes). Taxes derived from real estate ownership and transfer represent the largest source — in some cases approximately 70% — of local tax revenues, helping to pay for schools, roads, law enforcement and other essential public services. Real estate provides a safe and stable investment for individuals across the country, and notably, retirees. Over \$370 billion is invested in real estate and real estate-backed investments by tax-exempt organizations (pension funds, foundations, educational endowments and charities).

Commercial real estate is a capital-intensive asset, meaning that income-producing buildings require constant infusions of capital for acquisition and construction needs, ongoing repairs and maintenance, and to address tenants' ever-changing technological requirements.

Today's commercial real estate markets are grounded in strong fundamentals, as indicated by vacancy rates near historic lows, positive growth of rents and stable net operating income. By most measures, commercial real estate conditions accurately reflect market supply and demand.<sup>1</sup> While certain policy reforms are clearly warranted (*i.e.*, removing unnecessary barriers to construction lending, addressing internet sales tax issue), sources of equity and debt capital are largely available for economically viable projects. A broad-based acceleration of economic growth through tax reform would boost real estate construction and development and spur job creation. However, Congress should be wary of changes that result in short-term, artificial stimulus and a burst of real estate investment that is ultimately unsustainable and counterproductive. In order to improve the economy's long-term trajectory, growth must be predicated on sound reforms that change underlying economic conditions.

## **TAX REFORM**

The real estate industry agrees that tax reform is needed and overdue. We should restructure our nation's tax laws to unleash entrepreneurship, capital formation, and job creation. At the same time, comprehensive tax reform should be undertaken with caution, given the potential for tremendous economic dislocation. Tax policy changes that affect the owners, developers, investors and financiers of commercial real estate will have a significant impact on the U.S. economy, potentially in unforeseen ways.

We urge the Finance Committee to be mindful of how proposed changes in commercial real estate taxation could dramatically affect not only real estate investment activities but also the health of the U.S. economy, job creation, retirement savings, lending institutions, pension funds, and, of course, local communities.

Positive reforms will spur job-creating activity. For example, tax reform that recognizes and rewards appropriate levels of risk taking will encourage productive construction and development activities, ensuring that real estate remains an engine of economic activity. Tax reform can also spur job

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<sup>1</sup> The Real Estate Roundtable, *Sentiment Index: Second Quarter 2017* (May 5, 2017), available at: <http://www.rer.org/Q2-2017-RER-Sentiment-Index>.

creation, and assist the nation in achieving energy independence, by encouraging capital investments in innovative and energy-efficient construction of buildings and tenant spaces.

Alternatively, some reforms might unintentionally be counter-productive to long-term economic growth. Of major concern are proposals that could result in substantial losses in real estate values. Lower property values produce a cascade of negative economic impacts, affecting property owners' ability to obtain credit, reducing tax revenues collected by local governments and eroding the value of retirees' pension fund portfolios.

Thus, as much as we welcome a simpler, more rational tax code — and any associated improvements in U.S. competitiveness abroad — we continue to urge that comprehensive tax restructuring be undertaken with caution, given the potential for tremendous economic dislocation.

As history illustrates, the unintended consequences of tax reform can be disastrous for individual business sectors and the economy as a whole. A case in point is the Tax Reform Act of 1986, which ushered in a series of over-reaching and over-reactive policies — in some cases on a retroactive basis. Significant, negative policy changes applied to pre-existing investments. Taken together, these changes had a destabilizing effect on commercial real estate values, financial institutions, the federal government and state and local tax bases. It took years for the overall industry to regain its productive footing, and certain aspects of the economy never recovered.

We believe the four principles below should guide and inform your efforts to achieve a significant, pro-growth overhaul of the nation's tax code:

- Tax reform should encourage capital formation (from domestic and foreign sources) and appropriate risk-taking, while also providing stable, predictable, and permanent rules conducive to long-term investment;
- Tax reform should ensure that tax rules closely reflect the economics of the underlying transaction — avoiding either excessive marketplace incentives or disincentives that can distort the flow of capital investment;
- Tax reform should recognize that, in limited and narrow situations (*e.g.*, low-income housing and investment in economically challenged areas), tax incentives are needed to address market failures and encourage capital to flow toward socially desirable projects; and
- Tax reform should provide a well-designed transition regime that minimizes dislocation in real estate markets.

In short, 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.

### ***A BETTER WAY* – THE HOUSE REPUBLICAN TAX REFORM BLUEPRINT**

Last June, House Ways and Means Committee Chairman Kevin Brady (R-TX), House Speaker Paul Ryan (R-WI), and the House Republican Conference put forward *A Better Way*, a bold tax reform proposal aimed at creating a modern tax code built for economic growth. The drafters made clear

that this House Republican Tax Reform Blueprint (“Blueprint”) was the “beginning of our conversation about how to fix our broken tax code.” Our industry has appreciated the open dialogue and opportunity to work constructively with Members and staff in the House and Senate to ensure that tax reform achieves its full potential.

We support the Blueprint’s underlying objectives, including the desire to reform the tax system to promote economic growth, capital formation, and job creation. The comments below are based on our current understanding of the Blueprint, as gathered from meetings and conversations with Members and staff. Many of these perspectives have been transmitted to the tax-writing committees, formally or informally, in recent weeks. Our views and input will continue to evolve as additional information is made available. The comments are offered in the spirit of support for the tax reform effort, and they are aimed at ensuring the legislation successfully spurs economic growth without unintentionally discouraging entrepreneurship or creating unnecessary economic and market risks.

**Cash flow taxation and real estate.** The Blueprint would replace the existing system for taxing business income with a “destination-based, cash flow” tax system. Rather than taxing businesses on their net income, the Blueprint seeks to tax businesses on their net cash flow. For a domestic business, setting aside important aspects of the proposal that relate to cross-border transactions, the key conceptual change is that the full cost of a new investment would be recovered (deducted) immediately, rather than recovered (depreciated) over the economic life of the investment. The underlying expectation is that the shift to cash flow taxation will spur growth by reducing the tax burden on new investment.

The Blueprint proposes to deviate from cash flow taxation in two key ways that would have critical implications for real estate. First, land would not qualify for immediate expensing, only the value of structures. Second, businesses could not deduct currently their net interest expense. As a result, two major expenses associated with investing in real estate—the cost of the underlying land and the cost of borrowing capital to purchase the real estate—would be excluded from the basic architecture of the cash flow tax system.

- *Treatment of land.* Land represents a major share, on average roughly 30%, of the value of real estate. The Blueprint offers no express rationale for the exclusion of land from immediate expensing. The two suggestions offered informally to-date have been that land is a “non-wasting” asset and “we’re not making any more of it.” However, the actual economic life of an asset and its status as a manufactured good is irrelevant to a system that seeks to tax net cash flow. Under the Blueprint’s own terms, land should qualify for expensing. Denying taxpayers’ ability to expense land would create the very same economic distortions that the Blueprint is seeking to remove from the tax code. It would shift resources to other asset classes for reasons that are purely tax-motivated. In addition, it would create new geographic disparities and distortions based on the relative share of land in the cost of real estate.
- *Treatment of net interest expense.* Access to financing and credit is critical to the health of U.S. real estate and the overall economy. The ability to finance productive investment and entrepreneurial activity with borrowed capital has driven economic growth and job creation in the United States for generations. In both an income tax system and a cash flow tax system, business interest expense is appropriately deducted under the basic principle that interest is an ordinary and necessary business expense.

The Blueprint states that allowing both expensing and interest deductibility “would result in a tax subsidy for debt-financed investment.” The Blueprint “helps equalize the tax treatment of different types of financing” and “eliminates a tax-based incentive for businesses to increase their debt load beyond the amount dictated by normal business conditions.” The Blueprint suggests less leverage is inherently preferable, “A business sector that is leveraged beyond what is economically rational is more risky than a business sector with a more efficient debt-to-equity composition.”

Repealing or imposing limits on the deductibility of business interest would fundamentally change the underlying economics of business activity, including commercial real estate transactions. This could lead to fewer loans being refinanced, fewer new projects being developed, and fewer jobs being created. Legislation altering the tax treatment of existing debt could harm previously successful firms, pushing some close to the brink of insolvency or even into bankruptcy. Congress should preserve the current tax treatment of business interest. By increasing the cost of capital, tax limitations on business debt could dramatically reduce real estate investment, reducing property values across the country, and discouraging entrepreneurship and responsible risk-taking.

**Like-kind exchanges.** Under current law, section 1031 of the tax code ensures that taxpayers may defer the immediate recognition of capital gains when property is exchanged for property of a like kind. In order to qualify, a like-kind exchange transaction must involve property used in a trade or business, or held as an investment, and all proceeds (including equity and debt) from the relinquished property must be reinvested in the replacement property. Section 1031 is used by all sizes and types of real estate owners, including individuals, partnerships, LLCs, and corporations. While the Blueprint does not expressly address like-kind exchanges, we understand some policymakers view immediate expensing as a viable replacement for section 1031 of the tax code. We disagree.

Real estate like-kind exchanges generate broad economic and environmental benefits, and Section 1031 should be preserved without new limitations on the deferral of gains. Exchanges spur greater capital investment in long-lived, productive real estate assets and support job growth, while also contributing to critical land conservation efforts and facilitating the smooth functioning of the real estate market. Without Section 1031, many of these properties would languish underutilized and short of investment because of the tax burden that would apply to an outright sale. Recent academic research analyzing 18 years of like-kind exchange transactions found that they lead to greater capital expenditures, investment, and tax revenue while reducing the use of leverage and improving market liquidity.<sup>2</sup> Another study by EY concluded that new restrictions would increase the cost of capital, discourage entrepreneurship and risk taking, and slow the velocity of investment.<sup>3</sup> As currently understood, the Blueprint would not fully replicate the benefits of section 1031, particularly to the extent that the land component of real estate remains ineligible for immediate expensing.

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<sup>2</sup> Professors David C. Ling (Univ. Fla.) and Milena Petrova (Syracuse U.), *The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate* (June 2015), available at: [http://warrington.ufl.edu/departments/fire/docs/paper\\_Ling-Petrova\\_EconomicImpactOfRepealingOrLimitingSection1031.pdf](http://warrington.ufl.edu/departments/fire/docs/paper_Ling-Petrova_EconomicImpactOfRepealingOrLimitingSection1031.pdf).

<sup>3</sup> EY, *Economic Impact of Repealing Like-Kind Exchange Rules* (Nov. 2015), available at: <http://www.1031taxreform.com/1031economics>.

**State and local tax deduction.** State and local taxes are the principal source of financing for schools, roads, law enforcement and other infrastructure and public services that help create strong, economically thriving communities. Throughout the country, real estate is the largest contributor to the local tax base. Most state and local taxes, including real estate taxes, are deductible from federal income. Eliminating the deductibility of state and local taxes could disrupt demand for commercial real estate in many parts of the country while raising taxes on millions of Americans. It would shift power away from local communities in favor of the federal government. The deductibility of state and local taxes is grounded in the Constitution, federalism, and states' rights. The state and local tax deduction prevents an erosion of local governance and decision-making by prohibiting the federal government from double-taxing amounts already taxed at the state and local level. The burden of the change will fall disproportionately on those regions that generate the most tax revenue for the federal government—and the reduced demand for commercial real estate in certain regions could lower property values and limit the ability of the industry to continue creating jobs and driving economic growth.

**Blueprint impact on real estate investment and development.** Economic modeling suggests that the proposed shift to cash flow taxation under the Blueprint would create different results for different taxpayers—even after all real estate has transitioned to the new regime. For investors with other income that can absorb the losses generated by immediate expensing, the Blueprint should increase after-tax returns. For others, as a general matter, the relative after-tax returns on new real estate investment, including construction, would depend heavily on the interest rate that applies to loss carryforwards. Under reasonable financial assumptions related to property costs, operating income, and project expenses, a loss carryforward interest rate of 5.0% would result in after-tax returns on real estate investment that are similar to current returns. In contrast, a loss carryforward interest rate equal to inflation would result in returns that are much lower than those under current law. As interest rates rise or debt-to-equity ratios increase, returns on real estate investment would decline further because of the change in the tax treatment of business interest.

Thus, under the Blueprint framework, the tax burden may fall disproportionately on entrepreneurs and small developers—those most likely to own properties in small and medium-sized markets—because they use greater leverage to finance their activities and lack the deep portfolio of assets to absorb the losses generated from expensing.

Moreover, depending on the structure of the transition rules, the Blueprint could result in substantially lower after-tax returns and reduced property values for existing real estate assets. The impact on existing properties is heavily dependent on the post-enactment treatment of tax basis, as well as the ongoing deductibility of interest on existing and refinanced real estate loans. The structure of any transition relief under the Blueprint is not yet clear.

**Economic and market risks.** In the past (1981-1986), the accelerated tax depreciation of structures contributed to unsustainable levels of uneconomic, tax-motivated real estate investment and construction. Tax-driven stimulation of real estate construction that is ungrounded in sound economic fundamentals, such as rental income and property appreciation expectations, creates imbalances and instability in real estate markets. The negative consequences could harm state and local communities (through reductions in state and local property tax revenue), the financial security of retirees (through pension investments tied to real estate), and the banking system (through the declining value of real estate on bank balance sheets and systemic risk to the financial system).

Most capital assets other than real estate structures already are recovered on an extremely accelerated schedule. Therefore, the economic risks associated with immediate expensing are largely unique to real estate. According to Treasury Department economists, nearly half of all capital investment by U.S. corporations is in 3-year and 5-year property.<sup>4</sup> According to Goldman Sachs, under current tax policy, 70% of total capital investment is recovered within the first 18 months of use.<sup>5</sup> In addition to its longer life, real estate differs from other fixed capital assets because it is more likely to be sold for a gain. The income it generates often is treated as passive. In short, the tax attributes of real estate diverge greatly from other forms of capital investment.

Lastly, the stock of existing real estate dwarfs in size all other depreciable capital assets. And unlike equipment and machinery, only about two percent of the stock is replaced with new construction annually. The large existing stock relative to new construction means that transitioning existing real estate into a cash flow tax system in a manner that treats current owners fairly and avoids severe market disruption and systemic risk would be extraordinarily expensive from the standpoint of lost revenue to the Treasury.

**Going forward – addressing the challenges of real estate taxation under the House Blueprint.**

In light of the unique status of real estate as a long-lived, fixed capital asset and the transition challenges generated by the large stock of existing properties, the tax-writing committees should consider excluding real estate from the basic Blueprint architecture of immediate expensing and interest non-deductibility. Congress should preserve like-kind exchanges, an effective, time-tested tool that helps taxpayers internally mobilize capital to grow and expand their businesses and create jobs. Tax reform legislation could promote investment in manufacturing and other capital-intensive industries through a modified incentive that provides for permanent, immediate expensing of shorter-lived assets, such as equipment and machinery. Legislation could reduce the depreciation period for real estate to align more closely with its useful economic life, which is approximately 19 years, according to the Massachusetts Institute of Technology.<sup>6</sup>

Alternatively, if real estate is included in the cash flow tax system, it is critical that the legislation include carefully designed transition rules. The transition rules should ensure the new tax regime

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<sup>4</sup> James Mackie III & John Kitchen, *Slowing Depreciation in Corporate Tax Reform*, TAX NOTES (Apr. 29, 2013), available at: <http://www.taxnotes.com/tax-notes-today/budgets/slowng-depreciation-corporate-tax-reform/2013/04/30/f2p4> (behind paywall).

<sup>5</sup> David Mericle & Dan Stuyven, *Corporate Tax Reform: Trading Interest Deductibility for Full Capex Expensing* (Goldman Sachs Economics Research, Nov. 30, 2016), available at: <http://static.politico.com/c3/34/c99de58745b29f77b027a0f848d9/goldman-sachs-analysis-of-net-interest-deductibility-and-expensing-provisions-of-tax-reform.pdf>.

<sup>6</sup> Professor David Geltner and Sheharyar Bokhari, *Commercial Buildings Capital Consumption in the United States*, (MIT Center for Real Estate, Nov. 2015), available at: <https://mitcre.mit.edu/research-publications/commercial-building-capital-consumption-us>; Andrew B. Lyon & William A McBride, *Tax Policy Implications of New Measures of Building Depreciation*, TAX NOTES (June 20, 2016), available at: <https://www.pwc.com/us/en/tax-services/publications/assets/pwc-tax-implications-of-new-measures-of-building-depreciation.pdf>.

does not put the owners of existing real estate assets at an economic disadvantage compared to new construction and new investment; does not result in lower property values and new systemic economic risk; and does not create a lock-up of properties that distorts real estate commerce and undermines productive economic activity.

One approach to transition under consideration would grandfather current depreciation methods and schedules for existing assets. However, this approach would cement in law, for decades, two distinct tax systems for U.S. commercial real estate dependent on when the taxpayer acquired the property. This would result in two separate systems—one that is income-based for the \$15 trillion of existing real estate and one that is cash flow-based for future investment. In so doing, Congress risks creating a cascade of new market distortions with unknown and potentially dangerous consequences. It would violate a fundamental principle of good tax policy—treating similarly situated taxpayers the same. It could cause a lock-up of properties that reduces market liquidity, drags down property values, and prevents properties from transferring into the hands of owners that would upgrade and improve the real estate, creating jobs in the process.

In short, transition rules must address two powerful forces set in motion under the Blueprint—the loss of interest deductibility and the economic divergence that would result from the proposed acceleration of cost recovery for new investment. Both of these changes are challenges for the transition from one regime to the next.

In fairness to borrowers who made investment decisions in reliance on long-standing tax principles in place since the inception of our tax law, debt on existing real estate should be fully grandfathered for purposes of interest expense deductibility. This relief should extend to debt secured directly by real estate, as well as debt that is effectively backed by real estate, such as bonds issued by REITs. In addition, the transition rules should not discourage the refinancing of existing real estate debt, which accelerates reinvestment, economic activity, and job creation.

With respect to cost recovery, one viable option is to phase in immediate expensing over an extended period, while simultaneously accelerating the recovery of basis in existing assets. An alternative option would implement expensing immediately, but in contrast to the *American Business Competitiveness Act* (H.R. 4377, 114<sup>th</sup> Cong.), would ensure that current owners get full recognition of their tax basis when selling an existing asset, thus avoiding a “lump sum” tax on all existing real estate.

The importance of a well-designed transition regime cannot be overstated. The stock of existing commercial real estate is more than 12 times the size of total annual private investment in equipment and machinery. The risk of unintended consequences is real and past lessons should inform policymakers’ decisions. Congress should approach transition as a primary focus and not a secondary concern.

**Other real estate issues in the Blueprint.** There are several other areas where policy decisions in the legislative drafting of the Blueprint will have enormous consequences for commercial real estate activity. In brief:

- The 50% capital gains exclusion should fully cover individual gains from real estate investment, including real estate that is directly owned or owned through a pass-through entity;



- With respect to depreciation “recapture,” the tax law should recognize that a portion of the income received on the sale of real estate reflects the appreciation of the underlying land and is appropriately taxed at the reduced capital gains rate;
- The reduced tax rate on pass-through businesses should fully extend to partnerships, to distributions from REITs, and to other pass-through entities that generate real estate rental income;
- The new system should continue to encourage taxpayers to reinvest capital and earnings through provisions such as section 1031;
- In order to continue encouraging entrepreneurs and small developers to invest in U.S. real estate, the interest rate on loss carryforwards should include a real return that is sufficient to preserve the value of losses that cannot currently be used; and
- The character of real estate-related income, including carried interest, should continue to be determined at the partnership level and the new regime should continue to recognize that entrepreneurial risk-taking often involves more than just the contribution of capital.

**FIRPTA Repeal.** The punitive Foreign Investment in Real Property Tax Act (FIRPTA) regime subjects gains on foreign equity investment in U.S. real estate or infrastructure to a much higher tax burden than applies to a foreign investor purchasing a U.S. stock or bond, or an investment in any other asset class. In addition to the tax burden, the withholding and administrative filing requirements associated with FIRPTA are frequently cited by foreign taxpayers as principal reasons for avoiding the U.S. real estate market. FIRPTA is a major impediment to greater private investment in both U.S. real estate and infrastructure.

In 2015, Congress passed the most significant reforms of FIRPTA since its passage in 1980. Congress should build on the recent success by repealing FIRPTA outright as part of tax reform. Unleashed by FIRPTA’s repeal, capital from abroad would create jobs by financing new real estate developments, as well as the upgrading and rehabilitation of existing buildings. Architects, engineers, construction firms, subcontractors, and others would be put to work building and improving commercial buildings and infrastructure.

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Because commercial real estate is so ubiquitous, it is sometimes easy to overlook its positive connection to our nation. Commercial real estate is where America lives, works, shops, plays and invests. The right tax policy can help commercial real estate: create and maintain jobs, lift retirement savings for Americans, reduce energy consumption, and improve the quality of life in local communities.

We are fully committed to working with the Senate Committee on Finance to achieve a bold tax reform outcome that serves the overall economy and appreciate your consideration of these issues.

We appreciate your consideration of these comments and look forward to working with you, cooperatively, as tax reform moves forward.

Sincerely,

The Real Estate Roundtable  
ADISA—Alternative & Direct Investment Securities Association  
American Hotel & Lodging Association  
American Institute of Architects  
American Land Title Association  
American Resort Development Association  
American Seniors Housing Association  
Appraisal Institute  
Asian American Hotel Owners Association  
Associated General Contractors of America  
The Building Owners and Managers Association (BOMA) International  
CCIM Institute  
Federation of Exchange Accommodators  
Institute of Real Estate Management  
International Council of Shopping Centers  
IPA—Investment Program Association  
Mortgage Bankers Association  
NAIOP, the Commercial Real Estate Development Association  
National Apartment Association  
National Association of REALTORS®  
National Multifamily Housing Council  
REALTORS® Land Institute