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# STATEMENT FOR THE RECORD OF

# THE NATIONAL ASSOCIATION OF REALTORS®

## FOR THE

# UNITED STATES SENATE COMMITTEE ON FINANCE

## HEARING TITLED

# "BUSINESS TAX REFORM"

## ON

# SEPTEMBER 19, 2017

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Professionals who are members of the NATIONAL ASSOCIATION OF REALTORS®
and subscribe to its strict Code of Ethics.

EQUAL HOUSING OPPORTUNITY

## Introduction

The nearly 1.3 million members of the National Association of REALTORS® (NAR) thank the U.S. Senate Committee on Finance for holding this hearing on "Business Tax Reform."

NAR is America's largest trade association, including our eight affiliated Institutes, Societies and Councils, five of which focus on commercial transactions. REALTORS® are involved in all aspects of the residential and commercial real estate industries and belong to one or more of some 1400 local associations or boards, and 54 state and territory associations of REALTORS®.

## Tax Reform

NAR acknowledges the complexity of the current tax system and seeks tax reforms that support the goals of homeownership and freedom to buy, maintain and sell real estate. At the same time, the current real estate tax provisions are among the most widely used and most readily understood tax provisions. Millions of real estate investment decisions have been made with the current tax law factored in. Adversely changing the rules on existing investments could harm economic recovery and future job creation and would be unfair to those who relied on those rules.

Income-producing real estate is vital for strong economic growth and job creation, and great care must be taken in tax reform to ensure that current provisions that encourage those results not be weakened or repealed. Commercial real estate adds value to the places that we work, conduct commerce, live, and play.

### I. Section 1031 Like-Kind Exchanges

Since 1921, U.S. tax law has recognized that the exchange of one investment or business-use property for another of like-kind results in no change in the economic position of the taxpayer, and therefore, should not result in the immediate imposition of income tax. The like-kind exchange rules permit the deferral of taxes, so long as the taxpayer satisfies numerous requirements and consummates both a sale and purchase of replacement property within 180 days.

NAR strongly believes that the like-kind exchange provision in current law is vital to a well-functioning real estate sector and a strong economy, and must be preserved in tax reform. The like-kind exchange is a basic tool that helps to prevent a "lockup" of the real estate market. Allowing capital to flow more freely among investments facilitates commerce and supports economic growth and job creation. Real estate owners use the provision to efficiently allocate capital to its most productive uses. Additionally, like-kind exchange rules have allowed significant acreage of environmentally sensitive land to be preserved.

Section 1031 is used by all sizes and types of real estate owners, including individuals, partnerships, LLCs, and corporations. Moreover, a recent survey of our members indicated that 63 percent of REALTORS® have participated in a 1031 like-kind exchange over the past four years.

A 2015 study[1] found that in contrast to the common view that replacement properties in a like-kind exchange are frequently disposed of in a subsequent exchange to potentially avoid capital gain indefinitely, 88 percent of properties acquired in such an exchange were disposed of through a taxable sale. Moreover, the study found that the estimated amount of taxes paid when an exchange is followed by a taxable sale are on average 19 percent higher than taxes paid when an ordinary sale is followed by an ordinary sale. A second study by EY concluded that new restrictions on Section 1031 would increase the cost of capital, discourage entrepreneurship and risk taking, and slow the rate of investment.[2]

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[1] *The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate*, David C. Ling and Milena Petrova, March 2015, revised June 22, 2015.
[2] *Economic Impact of Repealing Like-Kind Exchange Rules*, EY, November 2015.

If one of the goals of tax reform is to boost economic growth and job creation, any repeal or limitation of the current-law like-kind exchange provision is a step in the wrong direction.

## II. Business Interest Deduction

Another recent tax reform idea with the potential to cause very serious disruption to the commercial real estate sector is the proposal to eliminate the deduction for net investment expense included in the House Republican Blueprint. 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. Since its inception, our tax system has appropriately allowed business interest expense to be deducted as an ordinary and necessary business expense.

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 new projects being developed, fewer jobs being created, and fewer loans being refinanced. Legislation altering the tax treatment of existing debt could harm successful firms, pushing some close to the brink of insolvency or even into bankruptcy.

Tax reform must preserve the current tax treatment of business interest. By increasing the cost of capital, limitations on business interest deductibility could dramatically reduce real estate investment, reducing property values across the country, and discouraging entrepreneurship and responsible risk-taking.

## III. Carried Interest

Many real estate partnerships utilize the common practice of providing additional incentives for a general partner to perform well by sharing some of the profits above a certain rate with them via a carried interest, even when they contributed little or no capital to the enterprise. The general partner's interest is "carried" with the property until it is sold, which can be a number of years after the enterprise is formed and limited partners have received profit distributions. That carried interest is then taxed at the capital gains rate, as a reward for entrepreneurs (general partners, in this case) who take the risks inherent in new projects.

The carried interest provision is an integral product of the flexibility Congress imbued in the tax rules for partnerships more than 50 years ago. The current tax treatment of carried interests is based on the established partnership tax principle that partners are taxed based on their share of partnership income (ordinary or capital gains), rather than based on the character of the partner (general or limited) to whom the income is allocated. The partnership structure has been a huge success, giving investors and entrepreneurs in many industries the tools to create and grow businesses, build shopping centers, found technology companies, and create millions of jobs.

Increasing the tax burden on these real estate partnerships, and particularly on those with operational expertise, by changing the treatment of a general partner's carried interest from capital gains to ordinary income would make real estate a less attractive investment. When the value of real estate investment is impaired, there is an indirect impact on all real estate. 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.

## IV. Depreciation

The current law depreciation rules are out of date and do not reflect the actual economic life of structures. The 27.5- and 39-year cost recovery periods should be shortened to a depreciable life for real estate that more accurately reflects the economic life of the property.

Independent studies indicate that the economic life of real property ranges between 18 and 30 years. Economic depreciation is more than just physical wear and tear, but also includes adjustments to the value of

real property caused by changes in tastes, new technology, and by improvements in the quality of new assets relative to old assets (obsolescence).

NAR and several other real estate-related trade associations funded academic research on the actual rate of economic depreciation of commercial and investment real property. The study results[3], released in early 2016, showed that the economic depreciation of real property is much shorter than the current tax rules provide, and is evidence that depreciable lives should *not* be extended in tax reform. Rather, we urge Congress to shorten the depreciable lives of structures to better reflect their true economic lives.

## Conclusion

Thank you for the opportunity to submit these comments. NAR appreciates the Senate Committee on Finance for its open and collaborative process as it seeks to reform our Nation's tax code. In order to devise a fairer and simpler tax code, the input of stakeholders at all levels is imperative to avoid unintended consequences.

Commercial real estate adds value to the U.S. economy at every level, and a well-tuned tax policy can help it continue to innovate, create jobs and add wealth to every community in the U.S. NAR looks forward to continued collaboration with this Committee as it works to devise a fairer and simpler tax code that boosts the overall economy.

[3] *Tax Policy Implications of New Measures of Economic Depreciation of Commercial Structures*, PwC, April 2016.