NAR Federal Taxation Committee

Issue Introduction Webinar

April 16, 2015

Welcome & Introductions

Brief Summary of Major NAR Tax Issues

Residential RE Issues

- Mortgage Interest Deduction
- Property Tax Deduction
- Exclusion of Gain on Sale of Principal Residence
- Mortgage Debt Forgiveness Tax Relief
- Tax Reform

Commercial & Investment RE Issues

- 1031 Like-Kind Exchanges
- Depreciation
- Capital Gains Tax Rates
- 3.8% Surtax on Net Investment Income
- Carried Interest
- FIRPTA
- Independent Contractor Safe Harbor
- Recapture of Depreciation
- Marketplace Fairness Act

Mortgage Interest Deduction (MID)

Summary

- Interest on loans up to $1 million deductible
  - Plus $100K of home equity loans
- Principal residence and a 2nd home
- Thresholds not indexed for inflation

Status & NAR Position

- Critics say MID is unfair & benefits mostly high-income people
- Alternative proposals:
  - Convert to a tax credit
  - Cap on itemized deductions
  - Lower max loan to $500K
  - Deny deductibility for loans on 2nd homes

NAR Position:

- MID is claimed by 71% of those whom it is designed to benefit
- Preserve current law
- Index thresholds for inflation

Property Tax Deduction

Summary

- Property taxes paid are generally fully deductible
  - Must be levied for general public welfare
  - Taxes for local improvements such as sidewalks not deductible

Status & NAR Position

- Some in GOP would like to repeal deductibility of all state & local taxes
  - On grounds that it subsidizes profligate state/local governments

NAR Position:

- Repeal or cutback in deduction not justified & would lead to double taxation
- 75% of benefit goes to those earning less than $200K per year

Exclusion of Gain on Sale of Principal Residence

Summary

- Homeowners may exclude up to $250K in gain ($500K if MFJ) on sale of principal residence
  - Added great deal of simplicity to tax rules
  - Thresholds not indexed for inflation

Status & NAR Position

- While some believe benefit is too rich, we have seen no serious threat

NAR Position:

- Provision should be preserved
- Thresholds should be indexed to inflation going forward

Mortgage Debt Forgiveness Tax Relief

Summary

- Under general tax law principles, debt forgiven is taxable income to debtor
  - Since 2007, Congress has passed series of temporary exclusions for mortgage debt on main home
  - Most recently expired 12/31/2014

Status & NAR Position

- While there is still lots of support to extend provision for another year or two, it is not as strong as last year
- Legislation not likely to move until larger package of expired provisions are extended, toward end of year

NAR Position:

- Provision should be made permanent
- In meantime, we are encouraging co-sponsorship of House & Senate bills to extend provision for 2 years, retroactive to beginning of 2015

Tax Reform (Individuals)

Summary

- President Obama does not seem interested in working with Republicans on tax reform affecting individuals
  - Most Democrats define tax reform as making higher-income people pay “fair share”
  - Most Republicans want to lower tax rates in hopes of generating economic growth
  - But in order to lower rates, some deductions, credits & exemptions will have to be repealed or curtailed

Status & NAR Position

- 2014 bill by W&M Chair Dave Camp repealed state & local tax deduction and greatly cut back on MID
- MID & property tax deduction are vulnerable but biggest danger is from increasing standard deduction

NAR Position:

- Tax system should be improved but first, do no harm
- Current tax incentives for home ownership must be preserved

Tax Reform (Corporate)

Summary

- President Obama is interested in pursuing corporate tax reform
  - Idea is to lower corporate tax rate to make U.S. more competitive with trading partners
  - However, lower rate would be “paid for” by repealing or reducing business tax benefits, such as depreciation and interest expense deductions
  - But reduced tax benefits could also hurt businesses operating in pass-through entities, such as partnerships, LLCs, S corporations
  - Tax-writing committees in Congress are looking for opportunities to work with President to see if common ground can be found in 2015

Status & NAR Position

- Most commercial and investment real estate is not owned by corporations, but by pass-through entities
  - Thus, real estate is threatened by corporate-only tax reform
- Issues most at risk include like-kind exchanges, depreciation, carried interest, and recapture rates

NAR Position:

- Corporate tax rate reduction should not be paid for by raising taxes on pass-through entities
- 1986 Tax Reform Act harmed real estate industry with changes having retroactive effect

1031 Like-Kind Exchanges

Summary

- Since 1921, tax law has allowed gain on exchange of business & investment property to be deferred if new property is of “like-kind”
- This has become key provision in real estate development
- Also important for residential customers of REALTORS who might have investment property

Status & NAR Position

- Like-kind exchanges face triple threat with 2014 tax reform plans in both House and Senate proposing repeal and Obama proposing cut-back
- Many Members of Congress are unaware of importance of provision to RE and some have perception that it is an unwarratned loophole

NAR Position:

- Like-Kind Exchanges are very important and must be preserved
- NAR is actively participating in 3 coalitions and actively lobbying and educating Members and staff on Capitol Hill

Depreciation

Summary

- Ability to recover cost of investment through depreciation is foundational to real estate investment
  - Changes to depreciation rules affect rate of return on investment
- Current law provides for depreciable lives of RE as follows:
  - 39 years for non-residential
  - 27.5 years for residential
  - 15 years for leasehold improvements (expired at end of 2014)

Status & NAR Position

- Lengthening depreciation lives for RE is tempting to tax-writers because it generates a lot of revenue in short-run that can be used to cut tax rates
- Both major 2014 tax reform plans would have lengthened depreciation for RE – one retroactively

NAR Position:

- Depreciation for tax purposes should be based on economic depreciation
  - Studies cited by those who advocate longer recovery periods are badly outdated
  - Obsolescence is a key factor in economic depreciation and has little to do with actual life of physical structure of buildings

Capital Gains Tax Rates

Summary

- Over history of U.S. tax code, capital gains have largely been taxed at a reduced rate to incentivize investment and to recognize fact that many gains are inflationary
- Current capital gains rates depend on income of taxpayer, and range from:
  - Zero rate (for those in tax brackets of 10% and 15%)
  - 15% for most taxpayers
  - 20% for those in highest tax bracket

Status & NAR Position

- Tax reformers are tempted to eliminate capital gains differential rate because it adds complexity to tax law
  - Many rules are in law to prevent taxpayers from converting ordinary income to capital gain
  - 1986 Tax Reform Act taxed eliminated lower tax rates for capital gains

NAR Position:

- NAR advocates for a meaningful differential between tax rates on ordinary income and capital gains

3.8% Surtax on Net Investment Income

Summary

- As part of the Affordable Care Act, Congress enacted new surtax on "net investment income" for certain higher-income taxpayers
  - Net Investment Income is comprised of net income from interest, dividends, capital gains, rents, annuities, and royalties
  - The tax applies to individuals with AGI above the following thresholds:
    - Married filing jointly - $250K
    - Single/head of household - $200K
  - The tax is 3.8% of the lesser of:
    - Net investment income, or
    - The execess of modified AGI over the thresholds above
- Example: Brett is single and has modified AGI of $220K, including $50K of capital gain.
    - Brett's surtax is $760 and is computed by finding the lesser of net investment income ($50K or the excess of the modified AGI over the threshold ($220K less $200K) or $20K and multiplying by 3.8%

Status & NAR Position

- We know of no changes being proposed to this tax under tax reform
  - This is still a new and little-understood tax and there was a lot of confusion among the public when it was enacted

NAR Position:

- NAR opposed this new tax vigorously and would like to see it reversed

Carried Interest

Summary

- A common practice among real estate partnerships is to give the general partner some of the profits through a "carried interest," even when he or she has contributed little or no capital
  - This profits interest is "carried" with the property until it is sold and is only realized if a profit is made and all limited partners receive their allocation
  - When the property is sold, the limited partners receive their profits distributions as capital gains
  - Under current law, the general partner's profits interest is also taxed as capital gains income

Status & NAR Position

- The Obama Administration and many in Congress believe carried interests should be taxed at ordinary income rates
  - Both the major tax reform plans in 2014 would treat carried interests as ordinary income
  - However, the Camp plan carved out RE, retaining capital gains tax treatment
- **NAR Position:**
  - NAR opposes proposals that would eliminate capital gains treatment for any carried interest of a RE partnership.
  - Capital gains treatment for income from a carried interest is seen as a reward for entrepreneurs who take the risks on new projects

FIRPTA

Summary

- The Foreign Investment in Real Property Tax Act (FIRPTA) was enacted in 1980 as a response to concerns about increasing foreign ownership of U.S. farm land.
  - Its major purpose was to establish equity of tax treatment between foreign/domestic investors of U.S. RE
  - Pending legislation would amend FIRPTA to allow more foreign ownership of REITs without triggering FIRPTA
  - This is a relatively modest provision that stops far short of repealing FIRPTA

Status & NAR Position

- Proponents of the legislation believe passage could attract billions in new overseas capital to U.S. commercial RE market
  - Opponents are concerned about giving foreign investors an edge over domestic owners of RE
- **NAR Position:**
  - NAR working group in 2014 studied issue and recommended policy that was adopted by BOD last May
    - NAR supports policies that encourage foreign direct investment in U.S. real estate through REITs that do not materially encroach upon the principle that all U.S. investors and foreign investors in U.S. real estate should be subject to similar sets of rules under the U.S. tax system

Indepenent Contractor Safe Harbor

Summary

- Section 3508 of Internal Revenue Code provides that "qualified real estate agents" and direct sellers are statutory independent contractors for all purposes of the tax code
  - This beneficial treatment has been in the law since 1982
  - To meet test, agents must be licensed, be paid based on sales and not hours worked, and have written contract with brokerage that they will not be treated as an employee

Status & NAR Position

- Even though many aspects of worker classification issue are hotly debated in Congress and in states now, there has been no direct threat to Section 3508 safe harbor
  - However, due to its importance, NAR is vigilant about this issue
- **NAR Position:**
  - NAR would oppose any erosion of the statutory protections in Section 3508

Depreciation Recapture Capital Gains Tax Rate

Summary

- Under current law, the amount of gain on sale of commercial and investment RE that is equal to depreciation that has been claimed on the property is subject to a 25% capital gains tax rate
  - This rate is a balanced solution that recognizes that recaptured depreciation should be taxed at a rate higher than the capital gains tax but generally lower than the rate on ordinary income

Status & NAR Position

- Both tax reform plans released in 2014 would have increased depreciation recapture capital gains rate to that of ordinary income
  - This would be a nearly 60% increase in tax rate on recaptured depreciation
- **NAR Position:**
  - NAR opposes raising taxes on the sale of real estate

Marketplace Fairness Act

Summary

- In 1992, Supreme Court ruled that Internet and catalog retailers are exempt from collecting sales tax unless they have physical presence, such as a store or warehouse, in the purchaser's state
  - Because many or most "remote" purchasers do not voluntarily pay the "use tax" equivalent of sales tax and this requirement is difficult to enforce, remote sellers have an advantage over "brick and mortar" stores that must charge sales tax
  - Also, local and state governments lose revenue, which must be made up, often through higher property taxes

Status & NAR Position

- Members of Congress in both Houses have introduced the "Marketplace Fairness Act" to require remote sellers to collect sales tax
  - The Senate passed the bill in 2013, but many House Republicans view it as a tax increase and are seeking other ways to address the issue
  - At present, the outlook for this issue is unclear
- **NAR Position:**
  - NAR supports legislation to "level the playing field" for all retailers