

NAR Issue Summaries

Federal Tax / Immediate Write-off (Expensing) of Commercial Buildings & Denial of Interest Expense Deductibility

NAR Committee:

Federal Taxation Committee

What is the fundamental issue?

When an individual or a business purchases real estate for investment or business purposes, the cost of the non-land portion of the property can be recovered for tax purposes through depreciation deductions. Under the current law, non-residential real estate is typically depreciated, or written off, over a 39-year period. The depreciation period for residential rental real estate is 27.5 years, while leasehold improvements are generally recovered over a 15-year period. In some very limited circumstances, real estate investments are eligible for immediate expensing, or for having the cost written off in the first year of the investment.

In the summer of 2016, the House Republican Leadership released a tax reform plan called the “Blueprint,” which features a fundamentally new idea for treating the tax recovery of business investments. The Blueprint would effectively repeal the current-law depreciation regime and allow investments and business assets to be written off, or immediately deducted, in the year they are placed in service. Thus, in a real estate context, the plan calls for the full cost of the non-land portion to be deducted in the first year, rather than over 39, 27.5, or 15 years.

Along with this policy change, the Blueprint also provides that interest expense would not be allowed to be deducted. The reason for this change would be to help prevent the ultra-fast write-off or cost recovery from creating a negative tax rate on investments, which many experts believe could lead to overinvestment and a return to abusive tax shelters.

The Blueprint is not a fully detailed document and it outlines general concepts rather than fully-fleshed out proposals. Therefore, many questions have arisen in connection with these ideas. For example, no one yet knows how such a plan would treat expenses in excess of income stemming from the immediate write-off of large purchases of real estate. Also, tax policy experts question whether passive real estate investors would really be allowed to claim immediate deductions from the purchase of real estate, especially if it is leveraged. Such treatment seems to reverse the passive loss rules that were instituted in the 1986 Tax Reform Act, which appears to be unlikely by many observers. Thus, there is a fair amount of skepticism that this proposal will really be as beneficial as initial reports seem to indicate, at least for some taxpayers. Further, the effect of not allowing the deduction for business interest expense cannot be fully evaluated until we see the details of how the proposal might work.

I am a real estate professional. What does this mean for my business?

Depreciation of real estate investments is a key policy issue. Everyone agrees that the tax rules should allow the cost recovery of wasting assets, such as buildings, but experts have long differed on the proper length of time for such cost recovery. The length of time that the tax law allows an investment in real estate to be recovered directly affects the economic returns on the investment and also its cash flows.

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Over past decades, we have seen depreciation regimes that are overly generous and have resulted in over-investment due to the tax benefits exceeding the economic common-sense of some investments. This happened in 1981 when depreciation for buildings was reduced to just 15 years, using an accelerated method. Just a few years later, policy makers recognized that this much-shorter recovery time resulted in large incentives to over-invest in real estate based on the tax benefits rather the economics of the deal.

Policy makers then overcorrected by lengthening recovery periods for real estate to today's rules, which most experts agree are longer than the actual amount of time that real estate should be depreciated, due to obsolescence and other factors.

The deductibility of interest expense is also a core aspect of the economics of real estate investment. Buildings and land are often highly leveraged investments, due to their high cost and long useful lives. From the advent of the Internal Revenue Code, the law has allowed interest expense to be fully deductible in the context of a trade or business or in the case of investments held for the production of income. A policy change that would deny this deduction would create a fundamental and negative shift in the economics of many or most real estate investments.

NAR Policy:

NAR believes tax recovery of real estate investment should be based on common-sense, and should neither be substantially faster nor slower than the actual rate of economic depreciation. Stability of rules is also an important factor, as many changes to the tax rules results in confusion and uncertainty, which can lower the level of economic growth and investment.

Presently, there is simply not enough detailed information about the immediate expensing idea to fully evaluate its possible effects on commercial and investment real estate. Assuming this idea moves forward as tax reform is debated, and details are released, NAR will study closely this proposal to determine its effect on the commercial real estate sector and on active and passive investors in real estate.

NAR would generally oppose the repeal of interest expense deductibility in relation to real estate investment. Deducting interest expense is an ordinary and necessary expense in the real estate industry and there is little, if any, rationale for it no longer being deductible.

Opposition Arguments:

Proponents of the immediate write-off idea believe that economic growth and job creation in America can be super-charged by a tax policy change that repeals cost recovery over time and instead allows a first-year write-off of all business investment, except for land.

At the same time, these proponents are concerned that the immediate expensing idea would be too beneficial if combined with interest expense deductibility. The worry here is that the combination of these changes would create a negative tax rate and encourage over-investment in real estate and other business and investment assets. This would also likely lead to tax shelters that are based on tax benefits of

investments overshadowing the actual economics of transactions.

Legislative/Regulatory Status/Outlook

The combination of the immediate expensing and interest non-deductibility proposals is interesting and unprecedented. While the concerns expressed by the developers of the Blueprint tax reform plan to meld the two changes to prevent unwarranted overinvestment in real estate are understandable, they also place the policy debate in this area into uncharted waters. Whether the beneficial aspects of a quicker cost recovery of real estate investment stemming from immediate expensing are enough to compensate for the loss of the deductibility of interest expense is impossible to determine without more information about the details of such a proposal, and study by economists and real estate experts. In the meantime, NAR will continue to watch these issues carefully and work with other involved and interested stakeholders to watch the development of the debate.

The larger tax reform debate, which has been ongoing for several years, is entering a period where it may be much more likely for congressional action to move Republican proposals toward enactment. Tax reform efforts of the past few years have been stymied by a wide gulf between Democratic and Republican policy goals for what tax reform is designed to accomplish, and by President Obama's unwillingness to take a leading role in pushing the Congress toward reform. Now that Republicans control more of the levers of power in Washington, GOP tax reform plans are much more likely to move forward and possibly be enacted.

Even so, tax reform faces many obstacles on many fronts. The two fundamental changes discussed here are sure to generate much debate and outside pressure both toward and against enactment. Large changes are generally harder to enact, and often take a long time to work through the legislative process. However, in an unusual year, big changes can occur relatively quickly.

In early 2017, it is impossible to accurately predict the outcome of the policy changes discussed here.

Current Legislation/Regulation (bill number or regulation)

None at this time.

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