NMHC/NAA Viewpoint

Treasury’s proposal to prevent multifamily firms that qualify as small businesses to elect out of limits on interest deductibility could significantly harm partners and S corporation shareholders who have multiple real estate investments. Curtailing the business interest deduction available to such taxpayers will increase the cost of debt financing, which will curb apartment construction at a time when the nation must build 4.6 million new units by 2030 to keep pace with demand.

The apartment industry relies on debt to construct new apartment properties and to upgrade existing properties.

BUSINESS INTEREST DEDUCTIBILITY

In response to concerns that firms might be overleveraged, Congress enacted the Tax Cuts and Jobs Act to cap the deductibility of business interest. Small businesses (i.e., businesses with average annual gross receipts of $25 million or less in the previous three years), including multifamily small businesses, may qualify for an exemption from this limitation. Multifamily real estate firms may also elect out of limitations on interest deductibility so long as they agree to depreciate real property under longer periods. However, proposed Treasury regulations limit this election to multifamily firms that do not qualify for the small business exemption.

Treasury’s proposal to prevent multifamily firms that qualify as small businesses to elect out of limits on interest deductibility could significantly harm partners and S corporation shareholders who have multiple real estate investments. Under the proposed rule, a partner or shareholder who does not itself meet the small business definition may be subject to interest disallowance from interest flowing from an interest in a small business (even if that business could otherwise be an electing real property trade or business).

We believe that the treatment of a flow-through entity that qualifies as both a small business and an electing real property trade or business under the proposed regulations is inappropriate, conflicts with Congressional intent, and is not required under the Tax Cuts and Jobs Act. We urge Treasury to correct this inequity as part of final business interest deductibility regulations.

Curtailing the deductibility of business interest would greatly increase the cost of debt financing. These higher costs will be expressed in one of two ways: either curbing development activity at a time when supply is falling well short of demand and/or possibly forcing an increase in rents for those properties that are built. In both cases, a tax law change such as this would make it more difficult for the multifamily industry to provide safe and decent housing to 39 million residents.

Over three-quarters of multifamily properties are owned by pass-through entities as opposed to stock-issuing corporations. Although these entities do raise equity capital from investors, they are largely reliant on the debt markets to finance new construction and/or property renovations as well as property operations. In fact, a typical multifamily deal is composed of 65 percent debt and 35 percent equity. On an overall basis, the Federal Reserve reports that as of December 31, 2018, total multifamily debt outstanding was $1.42 trillion.