



The National Multifamily Housing Council (NMHC) and the National Apartment Association (NAA) respectfully submit this statement for the record for the House Ways and Means Committee's May 18, 2017, tax reform hearing titled *How Tax Reform Will Grow Our Economy and Create Jobs*.

For more than 20 years, the National Multifamily Housing Council (NMHC) and the National Apartment Association (NAA) have partnered in a joint legislative program to provide a single voice for America's apartment industry. Our combined memberships are engaged in all aspects of the apartment industry, including ownership, development, management and finance. NMHC represents the principal officers of the apartment industry's largest and most prominent firms. As a federation of nearly 170 state and local affiliates, NAA encompasses over 72,000 members representing more than 8.4 million apartment homes throughout the United States and Canada.

## Background on the Multifamily Housing Sector

Prior to addressing the multifamily housing industry's recommendations for tax reform, it is worthwhile to note the critical role multifamily housing plays in providing safe and decent shelter to millions of Americans, as well as the sector's considerable impact on our nation's economy.

Today, 111 million Americans, over one third of all Americans, rent their housing (whether in an apartment home or single-family home).<sup>1</sup> There are 18.7 million renter households, or over 15 percent of all households, who live in apartments (properties with five or more units).<sup>2</sup> On an aggregate basis, the value of the entire apartment stock is \$3.3 trillion.<sup>3</sup> Our industry and its 38.8 million residents contributed \$1.3 trillion to the national economy in 2013 while supporting 12.3 million jobs.<sup>4</sup>

The U.S. is on the cusp of fundamental change in our housing dynamics as changing demographics and housing preferences drive more people away from the typical suburban house. Rising demand is not just a consequence of the bursting of the housing price bubble. In the five years ending 2016, the number of renter households was up by 5.8 million; homeowners were up by 1.3 million. Going back 10 years, there were 9.9 million new renter households and approximately 1.6 million new owner households. In other words, the growth in renter households precedes the 2008 housing crisis.<sup>5</sup>

Changing demographics are driving the demand for apartments. Married couples with children now represent only 21 percent of households. Single-person households (28 percent), single parent households (9 percent) and roommates (6 percent) collectively account for 43 percent of all households, and these households are more likely to rent.<sup>6</sup> Moreover, the surge toward rental housing cuts across generations. In fact, nearly 73 million Baby Boomers (those born between 1946 and 1964), as well as other empty nesters, have the option of downsizing as their children leave the house and many will choose the convenience of renting.<sup>7</sup> Over half (56.6 percent) of the net increase in renter households from 2006 to 2016 came from householders 45 years or older.<sup>8</sup>

Unfortunately, the supply of new apartments is falling well short of demand. An estimated 300,000 to 400,000 units a year must be built to meet expected demand; yet, on average, just 244,000 apartments were delivered from 2012-2016.<sup>9</sup> Furthermore, according to Harvard's America's Rental Housing, the

<sup>1</sup> 2015 American Community Survey, 1-Year Estimates, US Census Bureau "Total Population in Occupied Housing Units by Tenure."

<sup>2</sup> 2015 American Community Survey 1-Year Estimates, US Census Bureau, "Tenure by Units in Structure."

<sup>3</sup> NMHC estimate based on a report by Rosen Consulting. Updated 6/2014.

<sup>4</sup> National Multifamily Housing Council and National Apartment Association.

<sup>5</sup> NMHC tabulations of 2016, 2011, and 2006 Current Population Survey, Annual Social and Economic Supplement, US Census Bureau.

<sup>6</sup> 2015 Current Population Survey, Annual Social & Economic Supplement, US Census Bureau, "America's Families and Living Arrangements: 2015: Households (H table series), table H3 / Family groups (FG series), table FG6.

<sup>7</sup> Annual Estimates of the Resident Population by Single Year of Age and Sex for the United States: April 1, 2010 to July 1, 2015, US Census Bureau. Baby Boomers are defined as those born 1946 through 1964.

<sup>8</sup> NMHC tabulations of 2016 Current Population Survey, Annual Social & Economic Supplement, US Census Bureau

<sup>9</sup> US Census Bureau, New Residential Construction, updated 2/2016.

number of renter households could rise by more than 4.4 million in the next decade (depending upon the rate of immigration).<sup>10</sup>

The bottom line is that the multifamily industry provides housing to tens of millions of Americans while generating significant economic activity in communities nationwide. Changing demographics and growing demand will only cause the industry's footprint to expand in the coming years. As will be described below, tax policy will have a critical role to play in ensuring the multifamily industry can efficiently meet the needs of America's renters.

### **Key Priorities for Tax Reform**

Owners, operators and developers of multifamily housing, who favor pro-growth tax reform that does not disadvantage multifamily housing relative to other asset classes, have a considerable stake in the outcome of the debate over how to reform and simplify the nation's tax code. Industry participants pay federal tax at each stage of an apartment's lifecycle. Federal taxes are paid when properties are built, operated, sold or transferred to heirs.

In providing our recommendations, which we respectfully make below, we are guided by the principle that real estate relies on the free-flow of capital and that investment decisions are driven by after-tax rates of return rather than by statutory tax rates standing alone. Thus, the number of layers of taxation, the marginal rate of tax imposed on income, cost recovery rules, investment incentives and taxes imposed when properties are sold, exchanged or transferred to heirs are all critical in assessing the viability of an investment. In developing reform proposals, we recommend that the Ways and Means Committee and Congress certainly consider -- but also look well beyond -- lowering statutory tax rates and focus on the ability of a reformed system to efficiently allocate capital and drive job-creating business investment. As is outlined in the pages below, NMHC/NAA believe that any tax reform proposal must:

- Protect Pass-Through Entities from Higher Taxes or Compliance Burdens;
- Ensure Depreciation Rules Avoid Harming Multifamily Real Estate;
- Retain the Full Deductibility of Business Interest;
- Preserve the Ability to Conduct Like-Kind Exchanges;
- Maintain the Current Law Tax Treatment of Carried Interest;
- Preserve and Strengthen the Low-Income Housing Tax Credit;
- Maintain the Current Law Estate Tax; and
- Repeal or Reform the Foreign Investment in Real Property Tax Act to Promote Investment in the Domestic Apartment Industry.

NMHC/NAA recognize that the Ways and Means Committee is considering the House Republican Tax Blueprint that would move the nation from the current income tax toward a cash-flow tax.<sup>11</sup> This proposal would dramatically alter current-law cost recovery rules, principally by providing for the full expensing (instead of depreciation) of property held for investment (except land) and denying the deductibility of business interest. The multifamily industry's recommendations for tax reform that are made below are provided in the context of reforming the current-law income tax. The multifamily industry continues to analyze the House Republican Blueprint and is committed to working with the House Ways and Means Committee to consider a full range of options to achieve a viable plan. Following the discussion of our tax reform priorities, the multifamily industry offers a few preliminary thoughts on how the Blueprint may impact cost recovery.

### ***Priority 1: Tax Reform Must Not Harm Pass-Through Entities***

The multifamily industry is dominated by "pass-through" entities (e.g., LLCs, partnerships and S corporations) rather than publicly held corporations (i.e., C corporations). Indeed, over three-quarters of

<sup>10</sup> Harvard Joint Center for Housing Studies, "America's Rental Housing" (2015).

<sup>11</sup> A Better Way: Our Vision for a Confident America, Tax, June 24, 2016.

apartment properties are owned by pass-through entities.<sup>12</sup> This means that a company's taxable income is passed through to the owners, who pay taxes on their share of the income on their individual tax returns. This treatment contrasts with the taxation of large publicly held corporations that generally face two levels of tax. Those entities remit tax at the corporate level under the corporate tax system. Shareholders are then taxed upon the receipt of dividend income.

In addition to pass-through entities, a significant number of industry participants are organized as REITs. So long as certain conditions are satisfied, REITs pay no tax at the entity level. Instead, REIT shareholders are taxed on distributed dividends.

The multifamily industry opposes any tax reform effort that would lead to higher taxes or compliance burdens for pass-through entities or REITs. For example, while many are calling for a reduction in the nation's 35 percent corporate tax rate, flow-through entities should not be called upon to make up the lost revenue from this change.

### ***Priority 2: Ensure Depreciation Rules Avoid Harming Multifamily Real Estate***

Enabling multifamily developers to recover their investment through depreciation rules that reflect underlying economic realities promotes apartment construction, economic growth and job creation. Tax reform should ensure that depreciation tax rules are not longer than the economic life of assets by taking into account natural wear and tear and technological obsolescence.

In this regard, NMHC/NAA recommend that the Ways and Means Committee consider a recent study that suggests the depreciation of multifamily buildings should certainly be no longer than the current-law 27.5-year period and perhaps shorter. In particular, David Geltner and Sheharyar Bokhari of the MIT Center for Real Estate in November 2015 published a paper, *Commercial Buildings Capital Consumption in the United States*, which represents the first comprehensive study on this topic in nearly 40 years.<sup>13</sup> By including capital improvement expenditures, the MIT study finds that residential properties net of land depreciate at 7.3 percent per year on average, which is a significantly faster rate than previously understood. Translated into tax policy terms, *we believe this data shows that the current-law 27.5-year depreciation period overstates the economic life of an underlying multifamily asset by over eight years.*

The apartment industry would be particularly concerned by proposals to extend the depreciation period of multifamily buildings, such as those made in the past to set multifamily depreciation periods at 40 or even 43 years. These proposals, which would create an arbitrary and discriminatory cost recovery system that does not reflect the economic life of actual structures, would have a devastating effect on the apartment industry's ability to construct new apartment buildings, particularly when, as noted above, supply continues to fall short of demand. Extending the straight-line recovery period for residential rental property from 27.5 years to 43 years, for example, would reduce a multifamily operator's annual depreciation deduction by 36 percent. This result would diminish investment and development in multifamily properties, drive down real estate values and stifle the multifamily industry's ability to continue creating new jobs. Put another way, the proposal would significantly impact cash flows and investment returns that are at the heart of a developer's analysis of whether a particular project is economically viable.

Furthermore, it is not just property owners who would suffer the consequences of depreciation periods that do not reflect the economic life of underlying assets. For example, pension plans and life insurance companies, which provide retirement and income security to millions of working Americans and retirees, could be harmed as their real estate investments lose value. Local governments would also see lower revenues as the value of multifamily properties decline, leaving a smaller amount of property taxes to finance core services, including law enforcement and schools. In this regard, the Tax Foundation found

---

<sup>12</sup> US Census Bureau & US Dept. of Housing & Urban Development, *Rental Housing Finance Survey*, 2012.

<sup>13</sup> David Geltner and Sheharyar Bokhari, MIT Center for Real Estate, *Commercial Buildings Capital Consumption in the United States*, November 2015.

that in fiscal year 2014, property taxes accounted for 31.3 percent of state and local tax collections, more than general sales taxes individual income taxes and corporate income taxes.<sup>14</sup>

Finally, a note is warranted regarding so-called depreciation recapture. Under current law, when a multifamily property is sold, there are two types of taxes that apply. First, gain from the sale of the property is taxed as a capital gain, typically at a rate of 20 percent for a general partner and 23.8 percent for a limited partner. Second, the portion of the gain attributable to prior depreciation deductions is generally subject to a 25 percent tax. This second tax is referred to as depreciation recapture.

NMHC/NAA believe that depreciation recapture taxes as they stand today can have a pernicious effect on property investment and should be made no worse. After decades of operations, many multifamily owners have a very low tax basis in their properties. If sold under current law, owners would have to pay large depreciation recapture taxes. To avoid this huge tax bill, many current owners of properties with low tax basis will not only avoid selling their properties, but they will also be reluctant to make additional capital investments in properties. The result is deteriorating properties that are lost from the stock of safe, affordable housing. The other alternative is for the long-time owners to sell their properties to an entity that is able to pay a large enough sales price to cover the recapture taxes. To make their investment pay off, however, the new owner will likely convert the property to higher, market-rate rents, meaning a loss of our nation's affordable housing stock.

Therefore, either scenario can have the same result: the possible loss of hundreds of thousands of affordable housing units. Increasing depreciation recapture taxes will exacerbate this result and further discourage owners from selling these properties to entities that can retain them as affordable housing.

### ***Priority 3: Retain the Full Deductibility of Business Interest***

Under current law, business interest is fully deductible. However, efforts to prevent companies from overleveraging are leading to an examination of whether the current 100 percent deduction for business interest expenses should be curtailed. Unfortunately, curtailing this deductibility would greatly increase the cost of debt financing necessary for multifamily projects, curbing development activity.

As mentioned above, over three-quarters of multifamily properties are owned by pass-through entities. Although such entities can access some equity from investors, they must generally borrow a significant portion of the funds necessary to finance a multifamily development. A typical multifamily deal might consist of 65 percent debt and 35 percent equity. Because such entities often look to debt markets, which lend money at a rate of interest, to garner capital, the full deductibility of interest expenses is critical to promoting investment. Indeed, according to the Federal Reserve, as of December 31, 2016, total multifamily debt outstanding was \$1,186.7 billion.<sup>15</sup> Reducing the full deductibility of interest would undoubtedly increase investment costs for owners and developers of multifamily housing and negatively impact aggregate construction.

In addition to harming the multifamily industry, it is also instructive to note that modifying the full deductibility of business interest would be precedent setting. Drs. Robert Carroll and Thomas Neubig of Ernst & Young LLP concluded in their analysis, *Business Tax Reform and the Tax Treatment of Debt*:

The current income tax generally applies broad income tax principles to the taxation of interest. Interest expenses paid by borrowers are generally deductible as a business expense, while interest income received by lenders is generally includible in income and subject to tax at applicable recipient tax rates. With this treatment, interest income is generally subject to one level of tax under the graduated individual income tax rates. This

---

<sup>14</sup> Tax Foundation, *Facts & Figures, How Does Your State Compare?*, 2017, p. 14.

<sup>15</sup> Board of Governors of the Federal Reserve System, *Mortgage Debt Outstanding*, By type of property, multifamily residences, 2016Q4, March 2017.

is the same manner in which most other business expenses, such as wages payments to employees, are taxed, and also follows the practice in other developed nations.<sup>16</sup>

#### ***Priority 4: Preserve the Ability to Conduct Like-Kind Exchanges***

Since 1921, the Internal Revenue Code has codified the principle that the exchange of one property held for business use or investment for a property of a like-kind constitutes no change in the economic position of the taxpayer and, therefore, should not result in the imposition of tax. This concept is codified today in section 1031 of the Internal Revenue Code with respect to the exchange of real and personal property,<sup>17</sup> and it is one of many non-recognition provisions in the Code that provide for deferral of gains.<sup>18</sup>

Like-kind exchanges play a significant role and are widely used in the multifamily industry. Current-law like-kind exchange rules enable the smooth functioning of the multifamily industry by allowing capital to flow more freely, which, thereby, supports economic growth and job creation. Multifamily property owners use section 1031 to efficiently allocate capital to optimize portfolios, realign property geographically to improve operating efficiencies and manage risk. By increasing the frequency of property transactions, the like-kind exchange rules facilitate a more dynamic multifamily sector that supports additional reinvestment and construction activity in the apartment industry.

According to recent research by Drs. David C. Ling and Milena Petrova regarding the economic impact of repealing like-kind exchanges for real estate and the multifamily industry in particular:<sup>19</sup>

- Assuming a typical nine-year holding period, apartment rents would have to increase by 11.8 percent to offset the taxation of capital gains and depreciation recapture income at rates of 23.8 percent and 25 percent, respectively.
- Whether based on the number of transactions or dollar volume, multifamily properties, both large and small, are the property type most frequently acquired or disposed of with an exchange.
- Nearly nine in 10 (88 percent) of commercial properties acquired by a like-kind exchange result in a taxable sale in the very next transaction. Thus, like-kind exchange rules are not used to indefinitely defer taxes.
- Governments collect 19 percent more taxes on commercial properties sold following a like-kind exchange than by an ordinary sale.

---

<sup>16</sup> Drs. Robert Carroll and Thomas Neubig, *Business Tax Reform and the Tax Treatment of Debt: Revenue neutral rate reduction financed by an across-the-board interest deduction limit would deter investment*, Ernst & Young LLP, May 2012, p. 3.

<sup>17</sup> Section 1031 permits taxpayers to exchange assets used for investment or business purposes, including multifamily properties, for other like-kind assets without the recognition of gain. The tax on such gain is deferred, and, in return, the taxpayer carries over the basis of the original property to the new property, losing the ability to take depreciation at the higher exchange value. Gain is immediately recognized to the extent cash is received as part of the like-kind exchange, and the taxes paid on such gain serve to increase the newly acquired property's basis. Congress has largely left the like-kind rule unchanged since 1928, though it has narrowed its scope.

The like-kind exchange rules are based on the concept that when one property is exchanged for another property, there is no receipt of cash that gives the owner the ability to pay taxes on any unrealized gain. The deferral is limited to illiquid assets, such as real estate, and does not extend to investments that are liquid and readily convertible to cash, such as securities. Furthermore, the person who exchanges one property for another property of like-kind has not really changed his economic position; the taxpayer, having exchanged one property for another property of like-kind is in a nearly identical position to the holder of an asset that has appreciated or depreciated in value, but who has not yet exited the investment.

<sup>18</sup> Under the tax code, the mere change in value of an asset, without realization of the gain or loss, does not generally trigger a taxable event. In such situations, the proper tax treatment is to defer recognition of any gain and maintain in the new property the same basis as existed in the exchanged property. This is similar in concept to other non-recognition, tax deferral provisions in the tax code, including property exchanges for stock under Section 351, property exchanges for an interest in a partnership under section 721, and stock exchanges for stock or property under section 361 pursuant to a corporate reorganization.

<sup>19</sup> David C. Ling and Milena Petrova, *The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate*, June 2015.



Additional research suggests that like-kind exchanges play such a critical role in driving investment that repealing the ability to conduct them would harm the economy even if the resulting revenue were used to reduce tax rates. Indeed, Ernst & Young LLP estimates that repealing like-kind exchange rules and using the resulting revenue to enact a revenue-neutral corporate income tax rate reduction or a revenue-neutral business sector income tax reduction (i.e., encompassing both C corporations and flow-through entities) would reduce Gross Domestic Product by \$8.1 billion each year and \$6.1 billion each year, respectively.<sup>20</sup> Put another way, a tax rate reduction financed by repealing like-kind exchange rules would, on a net basis, harm the economy.

Ernst & Young LLP summed up its analysis of how repealing like-kind exchanges would impair investment by concluding, “While repealing like-kind exchange rules could help fund a reduced corporate income tax rate, its repeal increases the tax cost of investing by more than a corresponding revenue neutral reduction in the corporate income tax rate and reduces GDP in the long-run.”<sup>21</sup> This result, of course, moves in the opposite direction of one of the stated goals for tax reform put forward by many of its proponents.

### ***Priority 5: Maintain the Current Law Tax Treatment of Carried Interest***

A carried interest, also called a “promote,” has been a fundamental part of real estate partnerships for decades. Investing partners grant this interest to the general partners to recognize the value they bring to the venture as well as the risks they take. Such risks include responsibility for recourse debt, litigation risks and cost overruns, to name a few.

Current tax law, which treats carried interest as a capital gain, is the proper treatment of this income because carried interest represents a return on an underlying long-term capital asset, as well as risk and entrepreneurial activity. Extending ordinary income treatment to this revenue would be inappropriate and result in skewed and inconsistent tax treatment vis-à-vis other investments. Notably, any fees that a general partner receives that represent payment for operations and management activities are today properly taxed as ordinary income.

Taxing carried interest at ordinary income rates would adversely affect real estate partnerships. At a time when the nation already faces a shortage of affordable rental housing, increasing the tax rate on long-term capital gains would discourage real estate partnerships from investing in new construction. Furthermore, such a reduction would translate into fewer construction, maintenance, on-site employee and service provider jobs.

Notably, former House Ways and Means Committee Chairman Camp recognized the devastating impact that a change in the manner in which carried interest is taxed would have on commercial real estate when he specifically exempted real estate from a change he sought to the taxation of carried interest in his *Tax Reform Act of 2014*.<sup>22</sup>

Finally, some in Congress see the tax revenue generated by the carried interest proposal as a way to offset the cost of other tax changes. Enacting a bad tax law, such as changing the taxation of carried interest, merely to gain revenue to make other tax changes, is a distorted view of good tax policy, which demands that each tax proposal be judged on its individual merits.

### ***Priority 6: Preserve and Strengthen the Low-Income Housing Tax Credit***

The Low-Income Housing Tax Credit (LIHTC) has a long history of successfully generating the capital needed to produce low-income housing while also enjoying broad bipartisan support in Congress. This

---

<sup>20</sup> Ernst & Young LLP, *Economic impact of repealing like-kind exchange rules*, March 2015 (Revised November 2015).

<sup>21</sup> Ibid.

<sup>22</sup> H.R. 1, *Tax Reform Act of 2014*, Section 3621, Ordinary income treatment in the case of partnership interest held in connection with performance of services.

public/private partnership program has led to the construction of nearly 3 million units since its inception in 1986.<sup>23</sup> The LIHTC program also allocates units to low-income residents while helping to boost the economy. According to a December 2014 Department of Housing and Urban Development study, *Understanding Whom the LIHTC Program Serves: Tenants in LIHTC Units as of December 31, 2012*, the median income of a household residing in a LIHTC unit was \$17,066<sup>24</sup> with just under two-thirds of residents earning 40 percent or less of area median income.<sup>25</sup> Finally, the National Association of Home Builders reports that, in a typical year, LIHTC development supports approximately: 95,700 jobs; \$3.5 billion in federal, state and local taxes; and \$9.1 billion in wages and business income.<sup>26</sup>

Maintaining and bolstering the LIHTC's ability to both construct and rehab affordable housing is critical given acute supply shortages. Indeed, the Harvard Joint Center for Housing Studies estimated that there were only 58 affordable units for every 100 very low-income households (those earning up to 50 percent of area median income) in the United States in 2013.<sup>27</sup>

The LIHTC has two components that enable the construction and redevelopment of affordable rental units. The so-called 9 percent tax credit supports new construction by subsidizing 70 percent of the costs. Meanwhile, the 4 percent tax credit can be used to subsidize 30 percent of the unit costs in an acquisition of a project or new construction of a federally subsidized project and can be paired with additional federal subsidies.

Developers receive an allocation of LIHTCs from state agencies through a competitive application process. They generally sell these credits to investors, who receive a dollar-for-dollar reduction in their federal tax liability paid in annual allotments, generally over 10 years. The equity raised by selling the credits reduces the cost of apartment construction, which allows the property to operate at below-market rents for qualifying families; LIHTC-financed properties must be kept affordable for at least 15 years, but, in practice, a development receiving an allocation must commit to 30 years. Property compliance is monitored by state allocating agencies, the Internal Revenue Service, investors, equity syndicators and the developers.

First and foremost, Congress should retain the LIHTC as part of any tax reform legislation. In so doing, Congress must take care to offset any reduction in equity LIHTC could raise attributable to a reduction in the corporate tax rate. Furthermore, NMHC/NAA reminds Congress that tax-exempt private activity multifamily housing bonds are often paired with 4 percent tax credits to finance multifamily development, and that such tax-exempt bonds should be retained in any tax reform legislation as they play a critical role in making deals viable to investors.

Second, Congress should also look to strengthen the credit by both increasing program resources so that additional units can be developed or redeveloped and making targeted improvements to the program to improve its efficiency. Congress could increase program authority by allocating additional tax credits. Additionally, a part of the LIHTC that could benefit from a targeted adjustment involves program rules that require owners to either rent 40 percent of their units to households earning no more than 60 percent of area median income (AMI) or 20 percent to those earning no more than 50 percent of AMI. If program rules were revised to allow owners to reserve 40 percent of the units for people whose *average* income is below 60 percent of AMI, it could serve a wider array of households.

---

<sup>23</sup> National Council of State Housing Agencies, *2016 Housing Credit FAQ*, February 25, 2016.  
<https://www.ncsha.org/resource/2016-housing-credit-faq>.

<sup>24</sup> Department of Housing and Urban Development, *Understanding Whom the LIHTC Program Serves: Tenants in LIHTC Units as of December 31, 2012*, December 2014, p. 23.

<sup>25</sup> *Ibid*, p. 24.

<sup>26</sup> Robert Dietz, *The Economic Impact of the Affordable Housing Credit*, National Association of Home Builders, Eye on Housing, July 15, 2014. <http://eyeonhousing.org/2014/07/the-economic-impact-of-the-affordable-housing-credit/>.

<sup>27</sup> Harvard Joint Center for Housing Studies, "The State of the Nation's Housing 2015: Housing Challenges" (2015), available at <http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/jchs-sonhr-2015-ch6.pdf>

### ***Priority 7: Preserve the Current Law Estate Tax***

As part of the *American Taxpayer Relief Act of 2012* (P.L. 112-240), Congress in January 2013 enacted permanent estate tax legislation. The Act sensibly made permanent the \$5 million exemption level (indexed for inflation) enacted as part of the *Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010* (P.L. 111-312) and set a top tax rate of 40 percent. Crucially, it also retained the stepped-up basis rules applicable to inherited assets. As many apartment executives prepare to leave a legacy to their heirs, it is vital to have clarity and consistency in the tax code with regard to estate tax rules. For this reason, the apartment industry remains supportive of the permanent estate tax legislation passed in early 2013.

There are three key elements to the estate tax: (1) the exemption level; (2) the estate tax rate; and (3) the basis rules. While all three elements can be important for all types of estates, estates with significant amounts of depreciable real property are especially concerned with how various types of basis rules may affect them.

- **Exemption Levels:** The estate tax exemption level is, in simplified terms, the amount that a donor may leave to an heir without incurring any federal estate tax liability. In 2017, there is a \$5.49 million exemption.
- **Tax Rates:** The estate tax rate applies to the value of an estate that exceeds the exemption level. The maximum rate is 40 percent.
- **Basis Rules:** The basis rules determine the tax basis to the recipient of inherited property. There are generally two different ways that basis is determined—stepped-up basis and carryover basis. The estate tax today features stepped-up basis rules, and under this regime, the tax basis of inherited property is generally reset to reflect the fair market value of the property at the date of the decedent's death. By contrast, under carryover basis, the tax basis of the inherited properties is the same for heirs as it was for the donor. This includes any decreases in tax basis to reflect depreciation allowances claimed by the donor in prior years. Retaining a stepped-up basis rule is critical for estates that contain significant amounts of depreciated real property as it helps heirs reduce capital gains taxes and maximize depreciation deductions.

### ***Priority 8: Reform the Foreign Investment in Real Property Tax Act to Promote Investment in the Domestic Apartment Industry***

The Foreign Investment in Real Property Tax Act (FIRPTA) (P.L. 96-499) serves as an impediment to investment in U.S. commercial real estate, including multifamily housing. The FIRPTA regime is particularly pernicious because it treats foreign investment in real estate differently than investment in other economic sectors and, thereby, prevents commercial real estate from securing a key source of private-sector capital that could be used to develop, upgrade, and refinance properties. Congress should enact tax reform that either repeals FIRPTA or, at the very least, further mitigates its corrosive effect on foreign investment in U.S. real estate.

Under current law, the U.S. does not generally impose capital gains taxes on foreign investors who sell interests in assets sourced to the U.S. unless those gains are effectively connected with a U.S. trade or business. This means that a foreign investor generally incurs no U.S. tax liability on capital gains attributable to the sale of stocks and bonds in non-real estate U.S. companies.

FIRPTA, however, serves as an exception to the general tax rules and imposes a punitive barrier on foreign investment in U.S. real estate. Under FIRPTA, when a foreign person disposes of an interest in U.S. real property, the resulting capital gain is automatically treated as income effectively connected to a U.S. trade or business. Thus, the foreign investor is subject to a withholding tax on the proceeds of the sale only because it is associated with an investment in U.S. real estate.



In addition to levying tax, FIRPTA also mandates onerous administrative obligations that further deter foreign investment in U.S. real estate. First, the buyer of a property must withhold 15 percent of the sales price of a property sold by a foreign investor so as to ensure taxes are collected. Second, if they overpay tax through the withholding, foreigners investing in U.S. real estate must file tax returns with the IRS to receive a refund of the overpayment.

The taxes and administrative burdens FIRPTA imposes have negative consequences for U.S. commercial real estate and the multifamily industry. Because foreign investors can avoid U.S. tax and reduce their worldwide tax burden tax by investing in U.S. securities or in real estate outside of the U.S., they may simply choose not to invest in U.S. real estate. This is particularly harmful to an apartment industry that relies on capital to finance and refinance properties. Furthermore, because it is the sale of a U.S. property interest that triggers FIRPTA, foreign investors may hold on to U.S. real estate solely for tax considerations.

Repealing FIRPTA would ensure that tax considerations will not prevent capital from flowing to the most productive investments. Such reform could unlock billions in foreign capital that could help to both drive new investment and refinance real estate loans. If outright repeal proves impossible, Congress should consider additional targeted reforms to the FIRPTA regime. NMHC/NAA were particularly pleased that Congress in late 2015 enacted legislation to both provide a partial exemption from FIRPTA for certain stock of real estate investment trusts and exempt from the application of FIRPTA gains of foreign pension funds from the disposition of U.S. real property interests.<sup>28</sup>

### **The House Republican Tax Blueprint and Cost Recovery**

As noted above, the recommendations discussed in previous sections relate to reform of the current-law income tax. The House Republican Tax Reform Blueprint released in June 2016 represents a fundamental change in the way multifamily real estate would be treated for tax purposes. While it would reduce tax rates for the flow-through entities (e.g., LLCs, partnerships, and S corporations) that dominate the multifamily industry, the proposal, by moving from an income tax toward a cash-flow tax, dramatically alters the manner in which owners and investors recover their expenses. Under current law, multifamily real estate is depreciated over 27.5 years, all business interest may be deducted and properties can be like-kind exchanged to keep investment dollars in the real estate sector. In contrast, the House Republican proposal would provide for the immediate expensing of all assets—other than land—while denying interest deductibility. It is silent on like-kind exchanges.

The multifamily industry is continuing to evaluate the impact the House Republican proposal would have on the development of existing and future multifamily housing. The multifamily industry stands ready to work the Ways and Means Committee and Congress to refine this proposal as the policy development process moves forward. In the interim, we would offer the following preliminary observations.

First and foremost, the interest on debt, which has been fully tax deductible for 100 years, plays a critical role in developing multifamily real estate. Given the prevalence of the pass-through structure of ownership, multifamily entities are heavily reliant on debt markets – as opposed to equity markets that corporations access through the issuance of stock – to finance development. Accordingly, reducing the full deductibility of interest would standing alone increase investment costs for owners and developers of multifamily housing and negatively impact aggregate construction.

Second, it is unclear whether the benefits of full expensing would fully offset the loss of interest deductibility. This result is dependent on factors that include whether an entity is able to use the full value of an investment deduction in the year it is generated, the cost of capital, how much leverage a particular investor may choose to employ and statutory tax rates. In this regard, if the value of a deduction must be carried forward in the form of a net operating loss (NOL), it may be less beneficial. The House Republican tax plan proposes to allow NOLs to be carried forward indefinitely and to increase them by an interest

---

<sup>28</sup> Public Law 114-113, *Consolidated Appropriations Act, 2016, Division Q, Protecting Americans from Tax Hikes Act of 2015*.

factor that accounts for inflation and a real return on capital. It is uncertain how that real return on capital will be determined, but the formula will be critical. Given that a multifamily building may cost millions of dollars to construct, it is likely that many developers will have to recognize NOLs. If a real rate of return on capital is determined by reference to Treasury bonds, this will be substantially less valuable than a formula that references returns in equities markets. Until the Committee makes clear how NOLs will be calculated, the multifamily industry will be unable to fully analyze the House Republican proposal.

Third, it is critical to view cost recovery rules as a whole instead of in isolation. As noted above, current tax law, provides for depreciation, interest deductibility and like-kind exchanges. While expensing under the Blueprint may, in some cases, provide for a de facto like-kind exchange, this is not the case for land. Under the proposal, land, which can represent 15 percent to 25 percent of the cost of a typical multifamily deal, may not be expensed. Moreover, interest on land purchases may not be deducted. Thus, the tax treatment of land is materially worse under the House Republican tax plan than under current law that allows for interest deductibility. Although the Blueprint is silent on like-kind exchanges, members may wish to address this problem by retaining like-kind exchanges for land or continuing to allow interest deductibility on land.

Finally, while tax reform focuses on future investment, it is absolutely vital that policymakers do not diminish the value of current assets or adversely impact capital flows serving existing assets and the real estate industry. For this reason, transition rules to any future tax system will arguably be as essential as any new tax rules. This is especially true when it comes to how interest, depreciation and basis will be treated on existing multifamily debt.

According to the Federal Reserve, as of December 31, 2016, total multifamily debt outstanding was \$1.19 trillion. The multifamily industry strongly believes that debt serving existing assets should continue to be fully tax deductible as an ordinary and necessary business expense. Depreciation deductions on existing assets should also continue to be allowed under current law. Furthermore, owners of existing assets should be able to use current-law basis rules. Basis should not be reset to zero on the date of enactment as some have proposed. Any action to curtail interest deductions, diminish depreciation reductions or reduce basis attributable to existing assets has the capacity to greatly increase tax burdens and potentially lead existing multifamily investments to be uneconomic. This would greatly harm our industry's ability to house working Americans.

## **Conclusion**

In closing, NMHC/NAA look forward to working with the House Ways and Means Committee, as well as the entire Congress, to craft tax reform legislation that would promote economic growth and the nation's multifamily housing needs. In communities across the country, apartments enable people to live in a home that is right for them. Whether it is young professionals starting out, empty nesters looking to downsize and simplify, workers wanting to live near their jobs, married couples without children or families building a better life, apartment homes provide a sensible choice. We stand ready to work with Congress to ensure that the nation's tax code helps bring apartments, and the jobs and dollars they generate, to communities nationwide.