The National Multifamily Housing Council (NMHC) and the National Apartment Association (NAA) respectfully submit this statement for the record for the Senate Finance Committee's September 19, 2017, hearing titled *Business Tax Reform*.

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 more than 160 state and local affiliates, NAA encompasses over 73,000 members representing nearly 9 million apartment homes globally.

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, live in rental housing (whether in an apartment home or single-family home).[1] There are 18.7 million renter households, or nearly 16 percent of all households, who live in apartments (buildings with five or more units).[2] On an aggregate basis, the value of the entire apartment stock is $3.3 trillion.[3] Our industry and its 38.8 million residents contributed $1.3 trillion to the national economy in 2013 while supporting 12.3 million jobs.[4]

The U.S. is in the midst of a fundamental shift in our housing dynamics as changing demographics and housing preferences drive more people toward renting as their housing of choice. Today, demand for apartments is at unprecedented levels as the number of renters has reached an all-time high. Since 2010, the number of renter households has increased by an average of more than 800,000 annually – almost as much as 1.2 million a year, by some measures.[5] Meanwhile, apartment vacancy rates as measured by MPF Research fell or remained the same for seven straight years from 2009 to 2016.[6]

Changing demographics are driving the demand for apartments. Married couples with children now represent only 19 percent of households. Single-person households (28 percent), single parent households (9 percent) and roommates (7 percent) collectively account for 43 percent of all households, and these households are more likely to rent.[7] 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.[8] Over half (58.6 percent) of the net increase in renter households from 2006 to 2016 came from householders 45 years or older.[9]

Unfortunately, the supply of new apartments is falling well short of demand. Just-released research by Hoyt Advisory Services, Dinn Focused Marketing, Inc. and Whitegate Real Estate Advisors, LLC, *U.S. Apartment Demand – A Forward Look*, commissioned by NMHC/NAA shows that the nation will need 4.6 million

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[1] 2015 American Community Survey, 1-Year Estimates, US Census Bureau "Total Population in Occupied Housing Units by Tenure."
[2] 2015 American Community Survey 1-Year Estimates, US Census Bureau, "Tenure by Units in Structure."
[3] NMHC estimate based on a report by Rosen Consulting. Updated 6/2014.
[4] National Multifamily Housing Council and National Apartment Association.
[5] NMHC tabulations of American Community Survey and Current Population Survey microdata.
[6] MPF Research.
[7] 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.
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.
[9] NMHC tabulations of 2016 Current Population Survey, Annual Social & Economic Supplement, US Census Bureau.

new apartments by 2030, or an average of 328,000 units a year.[10] Just 244,000 apartments were delivered from 2012-2016.[11]

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, 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. 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 Finance Committee and Congress 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. We also urge the Committee to be mindful about how tax reform could impact existing investment and to focus on the critical transition rules that will be necessary to avoid disturbing the value of current assets. As outlined in the pages below, NMHC/NAA believe that any tax reform proposal must:

- Protect Pass-Through Entities from Higher Taxes or Compliance Burdens;
- Retain the Full Deductibility of Business Interest;
- Ensure Depreciation Rules Avoid Harming Multifamily Real Estate;
- 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.

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 apartment properties are owned by pass-through entities.[12] 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.

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[10] Hoyt Advisory Services, Dinn Focused Marketing, Inc. and Whitegate Real Estate Advisors, LLC, *U.S. Apartment Demand – A Forward* Look, May 2017, p. 38.
[11] NMHC tabulations of 2016 Current Population Survey, Annual Social & Economic Supplement, US Census Bureau.
[12] US Census Bureau & US Dept. of Housing & Urban Development, *Rental Housing Finance Survey*, 2015.

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.

Additionally, the multifamily industry would be extremely concerned by proposals that would arbitrarily limit the ability of current and future pass-through entities to fully utilize lower tax rates and other benefits tax reform may provide. Specifically, we would be troubled by proposals that would force pass-through income to be taxed at both the entity and individual levels or that would subjectively deem only a portion of such income received to qualify for a business tax rate that may be lower than individual tax rates. In other words, all legitimate business income, regardless of source (but taking into account reasonable compensation rules), should be eligible for a preferential business income tax rate.

Priority 2: Retain the Full Deductibility of Business Interest

Under current law, business interest is fully deductible. However, efforts to prevent companies from overleveraging are in part leading to an examination of whether the current 100 percent deduction for business interest expenses should be curtailed. Unfortunately, curtailing this deductibility – either in whole or in part – 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, many of which do not have access to public equity markets. Although such entities can access some equity from investors that are largely private, 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. Indeed, according to the Federal Reserve, as of March 31, 2017, total multifamily debt outstanding was $1.21 trillion.[13] Reducing the full deductibility of interest would undoubtedly increase investment costs for owners and developers of multifamily housing and negatively impact aggregate construction.

Finally, in addition to the harm it would cause, there is little policy justification for curtailing interest deductibility for the multifamily industry. Multifamily real estate is generally not held through corporations. As a result, there is no preference in the tax code for debt over equity. In other words, corporations favor debt over equity because they are able to deduct interest but not dividends. That is simply not an issue for the pass-through entities that dominate the real estate industry. With no problem to be solved, there is no need to effectively penalize the multifamily industry.

Priority 3: 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 Finance 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

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[13] Board of Governors of the Federal Reserve System, *Mortgage Debt Outstanding*, By type of property, multifamily residences, 2017Q1, June 2017.

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.[14] 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 nearly nine years.*

Additionally, a note is warranted regarding so-called deprecation 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.

Finally, the multifamily industry would like to commend Senators Thune and Roberts for introducing the *Investment in New Ventures and Economic Success Today Act of 2017* or the *INVEST Act of 2017* (S. 1144). By enhancing and making permanent Section 179 small business expensing and 50 percent bonus depreciation, the bill would encourage multifamily firms to increase investment. We particularly support the bill's provision to modify current-law Section 179 rules to enable property used in rental real estate, such as appliances and furnishings, to qualify for this incentive.

While we support the *INVEST Act of 2017*, we would note that we would be extremely concerned if Congress opted to enact the measure while curtailing the full deductibility of business interest. This is particularly the case because while the *INVEST Act* is a worthy piece of legislation that would promote business investment, it does not accelerate the depreciation period of real property, including multifamily buildings. Additionally, depending on the details of final legislation, it may be the case that benefits gained from accelerated depreciation – even if it encompasses real property – could fall short of losses brought on by the curtailment of interest deductibility. The multifamily industry asks to work with the Finance Committee to ensure that tax reform – with all provisions taken as a whole – spurs investment rather than unintentionally impedes real estate activity.

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

[14] David Geltner and Sheharyar Bokhari, MIT Center for Real Estate, *Commercial Buildings Capital Consumption in the United States*, November 2015.

section 1031 of the Internal Revenue Code with respect to the exchange of real and personal property,[15] and it is one of many non-recognition provisions in the Code that provide for deferral of gains.[16]

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:[17]

- 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.

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.[18] Put another way, a tax rate reduction financed by repealing like-kind exchange rules would, on a net basis, harm the economy.

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[15] 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.

[16] 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.

[17] David C. Ling and Milena Petrova, *The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate*, June 2015.

[18] Ernst & Young LLP, *Economic impact of repealing like-kind exchange rules*, March 2015 (Revised November 2015).

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."[19] 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*.[20]

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 public/private partnership program has led to the construction of nearly 3 million units since its inception in 1986.[21] 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[22] with just under two-thirds of residents earning 40 percent or less of area median income.[23] Finally, the National Association of Home

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[19] Ibid.
[20] 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.
[21] National Council of State Housing Agencies, *2016 Housing Credit FAQ*¸ February 25, 2016. https://www.ncsha.org/resource/2016-housing-credit-faq.
[22] 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.
[23] Ibid, p. 24.

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.[24]

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 45 affordable units for every 100 very low-income households (those earning up to 50 percent of area median income) in the United States in 2015.[25]

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.

In this regard, the multifamily industry strongly supports the *Affordable Housing Credit Improvement Act of 2017* (S. 548) and commends Senators Cantwell and Hatch for its introduction. We also thank Finance Committee Senators Wyden, Bennet, Heller, Isakson and Portman for their cosponsorship. Finally, we would also urge the Committee to strongly consider the *Middle-Income Housing Tax Credit Act of 2016* (S. 3384) that Ranking Member Wyden introduced during the 114th Congress to address the shortage of workforce housing available to American households. We believe that this bill would be a worthy complement of measures to expand and improve LIHTC.

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*

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[24] 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/.

[25] NMHC tabulations of 2015 American Community Survey public use microdata, IPUMS-USA, University of Minnesota, www.ipumgs.org.

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. Notably, a recent study finds that repealing FIRPTA would increase international investment in U.S. real estate by between $65 billion and $125 billion while generating between $26 billion and $49 billion in economic activity and creating between 147,000 and 284,000 direct and indirect jobs.[26]

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

[26] Kenneth T. Rosen, Randall Sakamoto, David Bank, Brett Fawley, Adam Eckstein, and Michael Stern, *Unlocking Foreign Investment in U.S. Commercial Real Estate*, June 2017.

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 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.[27]

Conclusion

NMHC/NAA look forward to working with the Finance 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.

[27] Public Law 114-113, *Consolidated Appropriations Act, 2016, Division Q, Protecting Americans from Tax Hikes Act of 2015.*