NATIONAL MULTIFAMILY HOUSING COUNCIL

TAX REFORM: STATE OF PLAY & STRATEGY FOR INDUSTRY

To: NMHC/NAA Members

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Subject: **Tax Reform Impact on Multifamily**

Tax reform is set to be on the forefront of the Congressional agenda in January 2017. This memo addresses:

1. Key tax issues in play for the multifamily industry.
2. State of play for tax reform on Capitol Hill.
3. Impact of the House Republican tax blueprint on the multifamily industry.
4. Strategy for moving forward.

The memo concludes with talking points to be used for discussing the industry's views with Congressional policymakers. Critically, these talking points may change as the tax reform process moves forward and specific provisions take shape.

Key Industry Priorities for Tax Reform: Tax reform has the capacity to fundamentally reshape the multifamily industry.

Apartment firms pay tax when they build, operate, sell or transfer communities to their heirs.

The multifamily industry plans to work with Congress and support a tax reform package that promotes economic growth and investment in rental housing without unfairly burdening apartment owners and renters relative to other asset classes. To this end, the industry has long advocated that tax reform must:

- **Protect Flow-Through Entities.** The multifamily industry is dominated by "flow-through" entities (e.g., LLCs, partnerships, S Corporations, etc.) as opposed to C corporations (public and private). This means that a firm's earnings are passed through to the partners who pay taxes on their share of the earnings on their individual tax returns. **Congress must not reduce corporate tax rates at the expense of flow-through entities.**

- **Maintain Like-Kind Exchanges.** Like-kind exchange rules enable property owners to defer capital gains tax if, instead of selling their property, they exchange it for another comparable property. These rules encourage property owners to remain invested in the real estate market. **Tax reform should recognize the current value of like-kind exchanges and retain incentives to invest in real estate.**

- **Retain the Deduction for Business Interest.** Multifamily developers generally borrow, in many cases as much as two-thirds of costs, to finance apartment development. Elimination of the current deduction for business interest expenses is being considered as part of a comprehensive tax overhaul. Elimination of business interest deductibility would greatly increase the cost of debt financing for projects, inhibiting development activity when the nation is suffering from a shortage of apartment homes. **Tax reform should retain incentives for real estate investment.**

- **Ensure Depreciation Rules Avoid Harming Real Estate.** Some have sought to raise revenue by significantly extending the 27.5-year depreciation period of multifamily buildings. Extending the depreciation period would reduce development and investment, leading to lower real estate values and stifling the industry's role in job creation. **Tax reform should reflect the critical role that cost recovery rules play in real estate investment.**

- **Protect the Low-Income Housing Tax Credit (LIHTC).** Reductions in the corporate rate have serious implications for the Low-Income Housing Tax Credit Program (LIHTC). The LIHTC program is a major financing incentive for low-income housing development. Downsizing the program would exacerbate the shortage of affordable rental units. **Tax Reform should ensure the viability of and strengthen the LIHTC program.**

Current State of Play: Both the Trump Administration and Congressional Republican leaders see tax reform as a top priority in 2017 and it is likely that tax reform will be under serious consideration as early as the spring of 2017.

U.S. House of Representatives

The Constitution dictates that all revenue-raising bills originate in the House of Representatives. In June 2016, House Republican leaders released a blueprint for tax reform, "A Better Way Forward for Tax Reform," which is expected to form the basis for legislation in that chamber. The proposal represents a sea change in the way the multifamily industry is taxed. The House Republican blueprint would:

- Reduce the top tax rate on pass-through entities to 25 percent from 39.6 percent;
- Tax capital gains, dividends, and interest at a maximum rate of 16.5 percent (the tax treatment of carried interest is not specifically addressed, but President Trump has proposed elimination);
- Allow all investment except for land to be immediately expensed instead of depreciated;
- Eliminate the deduction for business interest;
- Eliminate like-kind exchanges (except for land, these are effectively retained through the full expensing of investment);
- Eliminate the Low-Income Housing Tax Credit (NMHC/NAA staff, however, has learned that members of the Ways and Means Committee in December 2016 reportedly agreed to retain the LIHTC in any tax reform effort); and
- Repeal the estate tax while retaining stepped-up basis for inherited assets.

U.S. Senate

Senate Finance Committee Chairman Orrin Hatch (R-UT) has not yet released a plan for tax reform. While tax reform legislation will move first in the House and potentially influence a Senate product, Senator Hatch is likely to assert the Finance Committee's prerogative and move his own bill. Additionally, Senator Hatch has indicated his preference to try to move a bipartisan bill, and Senate Finance Committee Democratic staff recently noted numerous problems with the House blueprint. Should a bipartisan effort fail in the Senate, the chamber could then look to use the reconciliation process, which allows for bills to be fast-tracked, to move tax reform on a partisan basis.

Impact of the House Blueprint on the Multifamily Industry: NMHC/NAA continue to assess how the blueprint would impact the industry. We have identified the following positive and negative aspects:

Positive Proposals in the Blueprint:

- **Reduction of Tax Rates on Income and Capital Gains:** Top marginal income tax rate would fall to 25 percent from 39.6 percent, and top capital gains rate would fall to 16.5 percent from 23.8 percent (when net investment income taxes in the Affordable Care Act are included in calculations). It is unclear whether carried interest will be taxed at income or capital gains rates, but the rate would be 25 percent in the worse-case scenario.

- **Expensing of Investment and Implicit Like-Kind Exchanges:** Investment, except for land, would be expensed instead of depreciated over 27.5 years. Immediate cost recovery should incentivize investment. Additionally, expensing provides for a de facto like-kind exchange for all investment (except for land) in that a property owner can sell an asset and effectively defer gain on that asset by immediately purchasing another asset.

- **Repeal of the Estate Tax:** Repeals the estate tax and further protects heirs by providing for stepped-up basis on inherited assets. This means that only gains from the time of inheritance to the time of sale will be taxed.

Negative Aspects of the Blueprint:

- **Eliminates Deductibility of Business Interest:** The main negative proposal in the Blueprint is the elimination of business interest deductibility. It remains to be seen whether a 25 percent tax rate and full expensing of investment will be adequate to compensate for the loss of interest deductibility. Members of Congress believe that both expensing and interest deductibility are incompatible as such a policy would lead to a negative rate of investment. NMHC/NAA staff continues to remind policymakers of the critical role interest deductibility plays, particularly if all investment is not ultimately expensed.

- **Eliminates Like-Kind Exchanges for Land:** The immediate expensing of investment generally preserves like-kind exchanges, but the Blueprint denies a deduction for land purchases, as well as any associated interest expense. Like-kind exchanges for land only would also be unavailable. Given that land can represent 15 percent to 25 percent to the cost of a project, this could be a significant concern. NMHC/NAA staff is working with policymakers to ensure land receives more favorable treatment.

- **Jeopardizes Low-Income Housing Tax Credit Program:** As drafted, the Blueprint repeals the Low-Income Housing Tax Credit, the nation's driver of affordable housing production. NMHC/NAA staff has learned that members of the House Ways and Means Committee have reportedly reached agreement to retain the incentive. It will be critical to ensure this agreement is maintained, and that the value of the current-law credit is not diminished due to other proposed tax changes.

It is essential to emphasize that the Blueprint is a starting point for the tax reform debate. It is possible that during the tax reform process, the Blueprint could change, impacting other provisions. For example, the Blueprint provides for full expensing and, thereby, eliminates the deductibility of business interest and like-kind exchanges. Yet, Congress could ultimately determine that some property should be depreciated and that not all investment should be expensed. In such a case, the deductibility of business interest and like-kind exchanges would quickly become critically important for assets that could not be expensed.

Multifamily Industry Strategy for Tax Reform:

NMHC/NAA staff believes that tax reform will take several months to enact and that the Blueprint could evolve as the process moves forward.

Strategy involving continuous and sustained industry engagement with Members of Congress:

- The apartment industry should acknowledge the Blueprint given that it is the only comprehensive proposal currently in play and discuss both positive and negative aspects.
- Because the Blueprint is subject to change, it is also critical to discuss the industry's long-standing priorities for tax reform.
- Transition rules protecting existing deals and capital flows will be critical.

Proposed talking points are included at the end of this memo.

TAX REFORM TALKING POINTS

Tax Reform Generally

- Tax reform has the capacity to fundamentally reshape the multifamily industry, which provides safe and decent housing to 38.8 million Americans while contributing $1.3 trillion to the nation's economy and supporting 12.3 million jobs.
- Apartment firms pay tax when they build, operate, sell or transfer communities to their heirs.

Key Message: NMHC/NAA support tax reform that promotes economic growth and investment in rental housing without unfairly burdening apartment owners and renters.

House Blueprint

- The apartment industry is currently analyzing the House Blueprint, especially impact of a 25 percent rate and full expensing but no interest deductibility.
- Expensing would be positive for investment, but the loss of interest deductibility is detrimental.
- The treatment of land needs to be addressed given that it cannot be expensed and interest can't be deducted under the Blueprint.
    - Land can be worth 15 percent to 25 percent of a typical multifamily deal.
- Transition rules to a new tax system will be critical. Lawmakers must take care not to disrupt current investments and capital flows.

Key Message: The House blueprint is a starting point to tax reform. As the process moves forward we will need to analyze the various proposals in the tax reform package to determine how they impact real estate and specifically the multifamily industry.

Flow-Through Entities.

- The multifamily industry is dominated by "flow-through" entities (e.g., LLCs, partnerships, S Corporations, etc.) instead of C corporations.
- This means that a company's earnings are passed through to the partners who pay taxes on their share of the earnings on their individual tax returns.

Key Message: Congress must not reduce corporate tax rates at the expense of flow-through entities.

Like-Kind Exchanges

- Full expensing provides for de facto like-kind exchanges (with the exception of land).
    - If full expensing is not adopted as part of tax reform, maintaining current like-kind exchanges provisions is critical.
- Like-kind exchange rules encourage property owners to remain invested in the real estate market while providing them with the flexibility to shift resources to more productive properties, different geographic locations or to diversify or consolidate assets.
- Like-kind exchanges don't allow investors to defer tax indefinitely.
    - Eighty eight percent of properties acquired as part of a like-kind exchange result in a taxable sale in the very next transaction.

- Eliminating like-kind exchanges would increase rent burdens.
    - Assuming a 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.

Key Message: Tax reform should recognize the current value of like-kind exchanges and retain incentives to invest in real estate.

Carried Interest

- Current tax law properly treats carried interest as a capital gain.
- Carried interest represents a return on an underlying, long-term capital asset, as well as risk. Developers assume responsibility for risks, including recourse debt, litigation risks and cost overruns.

Key Message: Oppose proposals to change the tax treatment of carried interest.

Depreciation

- Setting aside the House Republican tax reform blueprint that calls for full expensing of investment, some lawmakers have sought to raise revenue by extending the 27.5-year depreciation period of multifamily buildings.
- Extending the depreciation period would reduce development and investment at a time when we have a severe shortage of workforce housing.
- A 2015 MIT study suggests that depreciation of multifamily buildings should not be longer than current law, and possibly shorter.

Key Message: Tax reform should reflect the critical role that cost recovery rules play in real estate investment.

Deductibility of Business Interest

- Full deductibility of business interest has been a tax code mainstay for 100 years.
- Curtailing the deduction will increase the cost of borrowing, which will curb apartment construction and/or further push up rents.
- Over three-quarters of multifamily properties are owned by pass-through entities as opposed to stock-issuing corporations. These entities are largely reliant on the debt markets to finance their operations. A typical multifamily deal is composed of 65 percent debt and 35 percent equity.

Key Message: Tax reform should retain incentives for real estate investment.

Low-Income Housing Tax Credit (LIHTC)

- Tax reform should retain and strengthen the LIHTC program.
- LIHTC is responsible for the financing of nearly 3 million apartments since its inception in 1986.
- Any reduction in the corporate rate will reduce the value of the LIHTC.
- LIHTC deals are already being impacted because of uncertainty around tax reform.

Key Message: Tax Reform should ensure the viability of and strengthen the LIHTC program.