# TAX REFORM

Lawmakers are calling for reform of the nation's tax code to foster economic competitiveness and economic growth. Tax reform has the capacity to fundamentally reshape the multifamily industry as it did after the passage of the last comprehensive tax reform law – the Tax Reform Act of 1986. Apartment firms pay tax when they build, operate and sell properties or transfer communities to their heirs. The industry has long supported the following principles for tax reform:

***NMHC/NAA Viewpoint***
***We support tax reform that promotes economic growth and investment in rental housing without unfairly burdening apartment owners and renters relative to other asset classes.***

- **Flow-Through Entities.** The multifamily industry is dominated by "flow-through" entities (e.g., LLCs, partnerships, S Corporations, etc.) instead of publicly-held corporations. This means the company'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**.

- **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.**

- **Deduction for Business Interest**. Multifamily developers generally borrow, in many cases as much as two-thirds of total cost, to finance apartment development. Eliminating the current deduction for business interest expenses is being considered as part of a comprehensive tax overhaul. Such an elimination would greatly increase the cost of debt financing for projects and inhibit development activity when the nation is suffering from a shortage of apartment homes. **Tax reform should recognize the key role that debt financing plays in real estate development.**

***More than 75 percent of multifamily firms are flow-through entities that pay taxes under the individual side of the code.***

- **Depreciation Rules.** Some have sought to raise revenue by significantly extending the 27.5-year depreciation period of apartments and increasing the 25 percent depreciation recapture tax rate applicable to sales. Cost recovery rules should reflect the life of properties. 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 cost recovery plays in our ability to create new jobs.**

- **Carried Interest.** Real estate development carries considerable financial risks. In fact, one in 10 multifamily projects never breaks ground. Because of the risks involved, many real estate partnerships use "carried interest" to encourage innovation and entrepreneurship. 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. **Current** tax **law properly treats carried interest as a capital gain.**

- **Low-Income Housing Tax Credit (LIHTC).** Reductions in the corporate rate have serious implications for LIHTC program, the major financing incentive for development of low-income housing. Undermining this public-private partnership would exacerbate the shortage of affordable rental units. **Tax Reform should ensure the viability of and strengthen the LIHTC program.**

Much is at stake for the apartment industry's ability to meet the nation's housing needs. NMHC/NAA support tax reform that promotes economic growth and investment in rental housing without unfairly burdening apartment owners and renters relative to other asset classes.

# ON POINT: TAX REFORM

## BACKGROUND

*Much is at stake for the apartment industry and its ability to meet the nation's housing needs given that apartment firms pay tax when they build, operate, sell or transfer communities to their heirs.*

*House Republicans released a Blueprint for tax reform in June 2016 that is expected to form the starting point for the debate. The proposal would significantly alter the taxation of multifamily real estate by reducing the top tax rate on the pass-through businesses dominating the sector to 25 percent; enabling all investment except for land to be immediately deducted from income as opposed to depreciated; and eliminating the deductibility of business interest.*

## KEY TALKING POINTS

- Tax reform has the capacity to fundamentally reshape the multifamily industry, as it did after the passage of the last comprehensive tax reform law – the Tax Reform Act of 1986.
- 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 REPUBLICAN BLUE PRINT

- The apartment industry is currently analyzing the House Blueprint, especially the 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 need to analyse both House and Senate proposals in their totality to determine how the multifamily industry will be impacted. NMHC/NAA supports six principle priorities for tax reform:**

**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 and some accounting for land in real estate transactions 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: Current tax law properly treats carried interest as a capital gain.**

**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 recognize the key role that debt financing plays in 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 LIHTC.**