



Issue Fact Sheet

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PRIORITY TAX ISSUES FOR THE APARTMENT SECTOR

Tax law plays an integral role in the ability of apartment firms to develop and maintain a sufficient supply of housing affordable to America's workforce. It can distort the flow of capital to the sector or even cause an outflow of capital. As the nation increasingly relies on apartments to house our citizens, we urge lawmakers to ensure that federal tax policy reflects the economic nature of investments in the financing of real estate. Top apartment industry priorities are detailed below.

Carried Interest

Although the Republican takeover of the House of Representatives reduced the threat of a carried interest tax increase, the proposal is reemerging in the context of legislation to raise the nation's \$14.3 trillion debt ceiling. President Obama and certain Congressional Democrats are seeking new tax revenues as part of a package to increase the debt ceiling and have floated carried interest as a potential revenue raiser. At this point, negotiations are ongoing, and NAA/NMHC are working with our allies to ensure carried interest is not included as part of any legislation that may emerge. Although some lawmakers see the tax revenue generated by the carried interest proposal as a way to offset the cost of other tax changes, the proposal would have numerous unintended consequences, including exacerbating the nation's affordable housing shortage.

Such a change would devastate real estate partnerships, causing a ripple effect for many of the industry's 550,000 workers and 16 million Americans who rely on the sector to provide them with safe, decent and affordable housing. It would make many development projects financially unviable, preventing much of the proposed new affordable housing from being built.

A "carried interest" (or "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 these partners bring to the venture as well as the risks (recourse debt, litigation risks, responsibilities for cost overruns, etc.) they take. 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 is inappropriate. In addition, any fees that a general partner receives that represent payment for operations and management activities are already properly taxed as ordinary income.

2001 and 2003 Tax Cuts and Tax Reform

Certainty in the nation's tax laws is a requirement for businesses, including apartment owners and investors, to make construction and hiring decisions. Because lawmakers were only able to pass a two-year extension of the Bush-era tax cuts, including reduced rates for capital gains and dividends, the industry faces an unknown future and the potential for significant tax increases in 2013 if Congress doesn't take action. NAA/NMHC urge lawmakers to clearly establish long-term certainty in our tax laws while simultaneously reducing complexity to the maximum possible degree. Importantly, any tax reform undertaken should maintain tax rates that favor investment, including the 15 percent capital gains tax rate, and should not otherwise disadvantage owners and renters of multifamily housing relative to other real estate and other asset classes.

Permanent Estate Tax Reform

After allowing the estate tax to lapse in 2010, President Obama and Congress in December 2010 reached an agreement to reinstate the levy for 2011 and 2012 with an exemption level of \$5 million (indexed for inflation after 2011) and a top tax rate of 35 percent. Without further action, in 2013, the tax will revert to a \$1 million exemption and a 55 percent rate, clearly an unacceptably low exemption amount and far too high a rate.

For property owners, the so-called basis, or property valuation, rules included in estate tax legislation are critical. These rules determine the tax basis of inherited property. There are generally two different types of basis rules—stepped-up basis and rollover basis. With a stepped-up basis (the law for all years except 2010 when the estate tax was repealed unless taxpayers elect to use 2011 rules), the tax basis of inherited property is reset to reflect the fair market value of the property at the time of the inheritance. By contrast, under rollover basis, the tax basis of the inherited properties is the

same for heirs as it was for the donor (i.e., the heir “steps into the shoes” of the donor with regard to tax basis). 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 essential for estates that contain significant amounts of depreciated real property, such as apartments. Repealing stepped-up basis not only harms heirs of commercial property, it can also have the unintended consequence of exacerbating the nation’s affordable housing shortage. In the interest of promoting certainty and stability in the tax code, NAA/NMHC urge Congress to swiftly enact permanent estate tax legislation that retains a stepped-up basis regime along with a \$5 million exemption and a 35 percent rate.

Low-Income Housing Tax Credit Program

Enacted in 1986, the Low-Income Housing Tax Credit (LIHTC) program has a long history of successfully generating the capital needed to produce low-income housing, and it has enjoyed broad bipartisan support in the Congress. In fact, according to the National Council of State Housing Agencies, the program has led to the construction of more than 2.4 million units for low-income families. This is especially critical given that only 44 affordable units are available to every 100 extremely low-income renter households. Finally, the National Association of Home Builders reports that prior to the financial crisis, the LIHTC program had created approximately 140,000 jobs and \$1.5 billion in state and local tax revenues on an annual basis.

With private capital returning to the LIHTC program and the tax credit exchange programs enacted as part of the *American Recovery and Reinvestment Act of 2009* having expired, NAA/NMHC are urging Congress to both maintain its strong support of the program as tax reform efforts move forward, as well as to make targeted changes to improve the program’s effectiveness. These include: (1) protecting the current structure of the LIHTC program as part of efforts to reform the nation’s tax code; (2) making the flat 9 percent LIHTC credit permanent; (3) increasing the flexibility of the LIHTC by allowing projects to elect an average-income criteria (e.g., allowing buildings to qualify if 40 percent of the units are occupied by tenants with incomes that *average* no more than 60 percent of area median income with no rent-restricted unit being occupied by a tenant with income over 80 percent of area median income.); and (4) extending by one year, through 2012, the placed-in-service date for Gulf Opportunity Zone LIHTC projects to help rebuild housing destroyed by Hurricanes Katrina and Rita.

Like-Kind Exchanges

Section 1031 of the Internal Revenue Code allows owners of commercial real estate to exchange properties without triggering a taxable event. Such tax-deferred exchanges enable an orderly flow of property ownership. Congress and the IRS should not alter the present like-kind exchange rules. Proposals to revise or restrict like-kind exchanges may have a significantly harmful effect on the value and trading of property.

Capital Gains, Depreciation Recapture and "Exit Tax" Relief

In 1997, when Congress reduced the maximum tax rate on long-term capital gains to 20 percent (for assets held more than 12 months), it imposed a 25 percent depreciation recapture rate on the portion of the gain assigned to the depreciable portion of a property. Thereafter, the capital gains tax rate was further reduced to 15 percent (through 2012), but the depreciation recapture rate was left unchanged. Imposing such a high depreciation recapture tax on apartment properties that have been depreciated from original cost fails to recognize the unique nature of commercial real estate property and discriminates against real estate in favor of other asset classes.

It also discourages long-term property owners from continuing to invest in their properties or sell them to entities that could maintain them as affordable housing. After decades of operations, many of these owners have a very low tax basis in their properties. If they were to sell them, they would have to pay large depreciation recapture taxes; in some cases, the tax liability may actually exceed the sales value of the property. To avoid this huge tax bill, many current owners will not only avoid selling their properties, but they will also be reluctant to make additional capital investments in properties with little value. The result is deteriorating properties that are lost as safe, affordable housing.

NAA/NMHC strongly support tax legislation that decreases both capital gains taxes and depreciation recapture rates. Congress should also enact legislation to provide apartment owners with “exit tax” relief from depreciation recapture taxes when the owners agree to sell their property to new owners who agree to invest new capital in the property and to preserve the property as affordable housing. Such a change would help America preserve its dwindling supply of affordable housing at a minimal revenue cost to the federal government.

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