



April 7, 2015

The Honorable Orrin Hatch  
Chairman  
Senate Committee on Finance  
219 Dirksen Senate Building  
Washington, DC 20510

The Honorable Ron Wyden  
Ranking Member  
Senate Committee on Finance  
219 Dirksen Senate Office Building  
Washington, DC 20510

Dear Chairman Hatch, Ranking Member Wyden and Members of the Senate Finance Committee:

The National Multifamily Housing Council (NMHC) and National Apartment Association (NAA) respectfully submit this letter for the record for the Senate Finance Committee's tax reform working group study. Given that owners and operators of multifamily properties pay federal taxes when properties are built, operated, sold, or transferred to heirs, as well as seek capital for community development and from international investors, we are including each of the five working groups in our submission so as to provide a comprehensive overview of our industry's tax reform priorities.

For more than 20 years, NMHC and 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 170 state and local affiliates, NAA is comprised of over 67,000 members representing more than 7.6 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 take a moment and note the fundamental 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, almost 108 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 17.9 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 \$2.5 trillion.<sup>3</sup> Our industry and its 36 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 shifting 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 in 2013, the number of renters was up by 4.2 million; the number of homeowners was down by 900,000. Moreover, the growth in renter households precedes the housing crisis. Compared with 10 years ago, there were 8 million new renter households and just 500,000 new owner households.

Changing demographics are driving the demand for apartments. Married couples with children now represent only 20 percent of households. Single-person households (28 percent), single parent households (18 percent) and roommates (7 percent) collectively account for 53 percent of all households, and these households are more likely to rent.<sup>5</sup> Moreover, the surge toward rental housing cuts across generations. In fact, 80 million Echo Boomers are beginning to enter the housing market, primarily as renters.<sup>6</sup> Furthermore, Harvard's Joint Center for Housing Statistics estimates that Millennials will create 24 million new households between 2015 and 2025.<sup>7</sup> At the same time, fully 77 million Baby Boomers have the option of downsizing as their children leave the house, and many will choose the convenience of renting.<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 just 186,200 apartments were delivered in 2013.<sup>9</sup> Furthermore, according to Harvard's *America's Rental Housing (2013)*, the number of renter households is expected to rise by 4.0 million to 4.7 million from 2013-2023 (depending upon the rate of immigration).<sup>10</sup>

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<sup>1</sup> 2013 American Community Survey, 1-Year Estimates, US Census Bureau "Total Population in Occupied Housing Units by Tenure by Units in Structure."

<sup>2</sup> 2013 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 Apartment Association and National Multifamily Housing Council.

<sup>5</sup> 2014 Current Population Survey, Annual Social & Economic Supplement, US Census Bureau.

<sup>6</sup> Annual Estimates of the Resident Population by Sex, Single Year of Age, Race Alone or in Combination, and Hispanic Origin for the United States: July 1, 2012, US Census Bureau. Echo Boomers are defined as those born 1977 through 1994.

<sup>7</sup> Harvard Joint Center for Housing Studies, *The State of the Nation's Housing* (2014), available at <http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/sonhr14-color-ch3.pdf>, p. 16.

<sup>8</sup> Annual Estimates of the Resident Population by Sex, Single Year of Age, Race Alone or in Combination, and Hispanic Origin for the United States: July 1, 2012, US Census Bureau. Baby Boomers are defined as those born 1946 through 1964.

<sup>9</sup> US Census Bureau, *New Residential Construction*, updated 6/2014.

<sup>10</sup> Harvard Joint Center for Housing Studies, *America's Rental Housing* (2013), available at [http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/jchs\\_americas\\_rental\\_housing\\_2013\\_1\\_0.pdf](http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/jchs_americas_rental_housing_2013_1_0.pdf), p. 14.

## **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. Put another way, 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 solely on statutory tax rates. 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 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 Estates;
- 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;
- Reform the Foreign Investment in Real Property Tax Act to Promote Investment in the Domestic Apartment Industry; and
- Improve Incentives for Energy Efficiency in Commercial Buildings and Large Multifamily Properties

### ***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) instead of publicly held corporations (e.g., C corporations). Indeed, over three-quarters of apartment properties are owned by pass-through entities.<sup>11</sup> This means that a company's taxable income is passed through to the partners, 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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<sup>11</sup> US Census Bureau & US Dept. of Housing & Urban Development, *Rental Housing Finance Survey*, 2012.

The multifamily industry opposes any tax reform effort that would lead to higher taxes or compliance burdens for pass-through entities. For example, given that Congress raised marginal tax rates on ordinary income to as high as 39.6 percent as part of the *American Taxpayer Relief Act of 2012* (P.L. 112-240), rates should certainly not be increased once again. Additionally, 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. Furthermore, flow-through entities should not be subjected to a corporate-level tax as President Obama proposed be examined in the White House's February 2012 report, *The President's Framework for Business Tax Reform*.<sup>12</sup> Finally, a corporate rate cut should not be financed by denying flow-through taxpayers credits and deductions.

### ***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 match the economic life of assets by taking into account natural wear and tear and technological obsolescence.

NMHC/NAA note that while we support depreciation periods that are set prospectively and reflect the economic lives of underlying assets, a retroactive cost-recovery proposal made in the 113<sup>th</sup> Congress by the staff of former Senate Finance Committee Chairman Baucus would have had 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. Former Chairman Baucus' staff discussion draft proposed to retroactively extend the tax recovery period for multifamily buildings from 27.5 years to 43 years<sup>13</sup> (a period well beyond economic life). The Baucus staff discussion draft also would have increased the 25 percent tax rate on recaptured depreciation to the ordinary income rate.<sup>14</sup> As with the change to depreciation rules, this proposal would also have been applied retroactively.

Extending the straight-line recovery period for residential rental property from 27.5 years to 43 years would reduce a multifamily operator's annual depreciation deduction by 36 percent. By creating an arbitrary and discriminatory cost recovery system that does not reflect the economic life of actual structures, the proposals 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.

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<sup>12</sup> White House and Department of the Treasury, *The President's Framework for Business Tax Reform*, February 2012, p. 10.

<sup>13</sup> United States Senate Committee on Finance, *Cost Recovery and Accounting Staff Discussion Legislative Language*, November 21, 2013, Section 11, Pooled asset cost recovery system and depreciation of real property.

<sup>14</sup> United States Senate Committee on Finance, *Cost Recovery and Accounting Staff Discussion Legislative Language*, November 2013, Section 12, Rules related to treatment of gains from depreciable property.

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 in 2013 found that at 35 percent of total revenues collected:

Property taxes were the most prominent source of state and local tax revenues in Fiscal Year 2010. This category includes both commercial and residential real estate in addition to personal property tax revenues obtained from taxes on cars, boats, etc. Residential and commercial real estate are often a source of local tax revenue, while personal property taxes are often a source of state tax revenue.<sup>15</sup>

As noted above, the apartment industry supports depreciation periods that match the economic life of assets. We believe that Congress must use credible and contemporary research to set depreciation periods and should do so on a prospective basis. NMHC/NAA note that to arrive at a 43-year depreciation schedule for real property, former Chairman Baucus' staff relied on assistance from the Congressional Budget Office that used data that is 40 years to 50 years old.<sup>16</sup> In particular, the estimates for the economic rate of depreciation for structures come from a Treasury study published in 1975 and a study by the National Bureau of Economic Research from 1963. These outdated studies do not reflect current economic realities, the degree of obsolescence caused by increasingly sophisticated technology now commonly found in buildings or the manner in which contemporary buildings are designed.

NMHC/NAA recommend that the Finance Committee consider two more recent studies that suggest the depreciation of multifamily buildings should certainly be no longer than the current-law 27.5-year period and perhaps shorter. Jeffrey D. Fisher, Brent C. Smith, Jerrold J. Stein, and R. Brian Webb in 2005 authored the article, *Analysis of Economic Depreciation for Multi-Family Property*, in the *Journal of Real Estate Research*. The authors found that if a 3 percent rate of inflation is assumed, an investment-grade multifamily building depreciates over a 26.2-year period. A 2 percent inflation rate would imply a 30.5-year depreciation period.<sup>17</sup> Notably, the Congressional Budget Office in its January 2015 report, *The Budget and Economic Outlook: 2015*

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<sup>15</sup> Liz Malm and Ellen Kant, Tax Foundation, *The Sources of State and Local Tax Revenues*, January 28, 2013.

<sup>16</sup> The Congressional Budget Office released a letter in November 2013 that states, "CBO was asked [by Finance Committee staff] to estimate the length of the period under the straight-line approach that would generate the same value of depreciation deductions for real property as would applying the average economic depreciation rate after adjusting for inflation. CBO estimates that period to be 43 years." Letter from CBO Director Douglas W. Elmendorf to Chairman Max Baucus, *Information on the Depreciation of Assets* (Nov. 21, 2013), <http://www.cbo.gov/publication/44911>. A footnote in the CBO letter states: "The U.S. Bureau of Economic Analysis (BEA) computes economic depreciation rates for most asset types, which occasionally vary by industry (see BEA Depreciation Estimates, 2004, [www.bea.gov/national/FA2004/Tablecanandtext.pdf](http://www.bea.gov/national/FA2004/Tablecanandtext.pdf))." The data on which BEA relies is from National Bureau of Economic Research and Treasury Department studies conducted in the 1960s and 1970s.

<sup>17</sup> Jeffrey D. Fisher, Brent C. Smith, Jerrold J. Stein, and R. Brian Webb, *Analysis of Economic Depreciation for Multi-Family Property*, *Journal of Real Estate Research*, Vol. 27, No. 4 – 2005.

to 2025 estimates a long-term CPI-U inflation rate of 2.4 percent. Interpolating the Fisher et al. data, this leads to a depreciation rate of approximately 27.9 years. Additionally, it should be noted that a June 2000 Deloitte & Touche LLP study, *Analysis of the Economic and Tax Depreciation of Structures*, found a real 23-year depreciation period for residential real property.<sup>18</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. 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.

Former Chairman Baucus' staff discussion draft proposed to retroactively repeal the 25 percent depreciation recapture rate and tax all depreciation recapture as ordinary income, potentially at rates of up to 39.6 percent.<sup>19</sup> NMHC/NAA believe that depreciation recapture taxes as they stand today already can have a pernicious effect on property investment and should, at the very least, be left at current law rates.

After decades of operations, many multifamily owners have a very low tax basis in their properties. If they were to sell them, they, even under current law, would have to pay large depreciation recapture taxes. 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 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.

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<sup>18</sup> Deloitte & Touche LLP, *Analysis of the Economic and Tax Depreciation of Structures*, June 2000, p. 34.

<sup>19</sup> Chairman Baucus' staff discussion draft proposal did not set new and potentially lower rates for ordinary income, but the current-law top rate is 39.6 percent.

As mentioned above, over three-quarters of multifamily properties are owned by pass-through entities. Although such entities can access equity from investors, they must generally borrow a significant portion of the funds necessary to finance a multifamily development. In fact, 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, 2014, total multifamily debt outstanding was \$994.1 billion.<sup>20</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. In fact, 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 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>21</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>22</sup> and it is one of many non-recognition provisions in the

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<sup>20</sup> Board of Governors of the Federal Reserve System, *Mortgage Debt Outstanding*, By type of property, multifamily residences, 2014Q4, March 2015.

<sup>21</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>22</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

Code that provide for deferral of gains.<sup>23</sup> The Obama Administration's Fiscal Year 2016 budget targeted section 1031 by substantially restricting the provision with respect to real property by limiting the amount of gain that may be deferred to \$1 million annually.<sup>24</sup> Former Senate Finance Committee Chairman Baucus' November 2013 staff discussion draft proposal sought to repeal the ability to undertake like-kind exchanges.<sup>25</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 Dr. Milena Petrova, who used data from the commercial real estate information company CoStar, from 1999 to 2005, tax-deferred exchanges represented approximately 30 percent of apartment transactions.<sup>26</sup> Notably, Petrova found that percentage remained remarkably stable during 1999-2005.<sup>27</sup> She also was able to conclude that "among other property types, exchanges generally account for 10-18 percent of all transactions."<sup>28</sup> Finally, Petrova's analysis shows that between 1999 and 2005, like-kind exchanges were involved in a substantial percentage of transactions in key markets served by Finance Committee members: Columbus (43.65 percent), Denver (47.21 percent), Las Vegas (37.20 percent), Portland (68.98 percent), Salt Lake City (35.00 percent), and Seattle (53.38 percent).<sup>29</sup>

Just-released 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, in a March 2015 analysis, estimates that repealing like-kind exchange rules and using the resulting revenue to

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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>23</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>24</sup> Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals*, Modify Like-Kind Exchange Rules for Real Property and Collectibles, p. 111.

<sup>25</sup> United States Senate Committee on Finance, *Cost Recovery and Accounting Staff Discussion Legislative Language*, November 2013, Section 15, Repeal of like-kind exchanges.

<sup>26</sup> Dr. Milena T. Petrova, *Do Buyer and Seller Motivations Affect Transaction Prices in Commercial Real Estate Markets? Evidence from Tax-Deferred Exchanges and Other Conditions of Sale*, A Dissertation Presented to the Graduate School of the University of Florida, 2006, p. 44.

<sup>27</sup> *Ibid.*, p. 44.

<sup>28</sup> *Ibid.*, p. 44.

<sup>29</sup> *Ibid.*, p. 46.

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 (GDP) by \$8.1 billion each year and \$6.1 billion each year, respectively.<sup>30</sup> Put another way, a tax rate reduction financed by repealing like-kind exchange rules would, on a net basis, harm the economy.

One of the main reasons that GDP would decrease if the like-kind exchange rules were repealed is that such a policy would increase the cost of capital and, therefore, negatively impact investment, a key ingredient of economic growth. Indeed, Ernst & Young LLP data shows a repeal of like-kind exchange rules would cause overall investment in the economy to decline by \$7.0 billion per year if revenue from repeal were used to reduce corporate tax rates and by \$4.8 billion per year if revenue from repeal were used to reduce business sector income tax rates.<sup>31</sup>

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 tax rate. That is, rather than making the United States a more attractive place to invest, these results suggest this policy shift would leave the United States a less attractive place to invest.<sup>32</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.

It should also be pointed out that the ability to defer gain through a like-kind exchange could well lead to lower levels of debt and leverage in multifamily transactions. The buyer of a replacement multifamily property in a like-kind exchange is more likely to have a higher down payment because a failure to reinvest funds generated from an exchange sale results in immediate tax liability. Additionally, repealing the ability to undertake like-kind exchanges and requiring multifamily businesses to pay tax on the sale of an asset increases the cost of equity financing. Given this increase in the cost of equity, debt financing becomes relatively less costly and more attractive.

Finally, it should be noted that the ability to undertake like-kind exchange also contributes to local government budgets given that sale of real estate generates significant property transfer and recording fees. Repealing the like-kind exchange rules would very likely cause owners of multifamily properties to hold on to their investments for a longer period to forestall the recognition of taxable gain.

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<sup>30</sup> Ernst & Young LLP, *Economic impact of repealing like-kind exchange rules*, March 2015.

<sup>31</sup> *Ibid.*

<sup>32</sup> *Ibid.*

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

NMHC/NAA would also like to use this opportunity to underscore our strong opposition to proposals to change the current law governing the tax treatment of carried interest. If enacted, this proposal would significantly reduce the ability to develop or rehab apartments across the nation.

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 5.3 million unit 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 during a period in which the unemployment rate remains abnormally high.

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>33</sup> Moreover, in 2010, both the U.S. Conference of Mayors and the National Association of Counties passed resolutions opposing the carried interest proposal as it relates to real estate partnerships and urged Congress to maintain the current law capital gains treatment of carried interest, noting that any change would bring extremely negative consequences to communities throughout the country.<sup>34</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

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<sup>33</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.

<sup>34</sup> Resolutions Adopted by the Members of the U.S. Conference of Mayors, *Carried Interest*, 78<sup>th</sup> Winter Meeting, Washington, DC, 2010. [http://www.usmayors.org/resolutions/78th\\_Winter\\_Conference/res\\_CarriedInterest.pdf](http://www.usmayors.org/resolutions/78th_Winter_Conference/res_CarriedInterest.pdf). National Association of Counties, *Resolution Urging Congress to Maintain the Current Capital Gains Tax Treatment of “Carried Interest” Used by Real Estate Partnerships*, Adopted March 8, 2010. [https://www.novoco.com/hottopics/resource\\_files/naco\\_carried-interest\\_030910.pdf](https://www.novoco.com/hottopics/resource_files/naco_carried-interest_030910.pdf).

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 2.8 million units since its inception in 1986.<sup>35</sup> The LIHTC program also allocates units to low-income residents while helping to boost the economy. In fact, 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>36</sup> with just under two-thirds of residents earning 40 percent or less of area median income.<sup>37</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>38</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 a nationwide affordable housing shortfall of 5.3 million units in 2011. This is more than double the shortfall observed in 2001. Between 2001 and 2011, 650,000 housing units with rents of \$400 or less were permanently removed from the housing stock. An additional 560,000 affordable units that are currently occupied by low-income households are characterized as structurally inadequate. Finally, the total number of "severely cost-burdened households" (those paying more than half their income on housing) for low-income households with someone working full-time increased from 38.6 to 42.4 percent from 2007 to 2011.<sup>39</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. In contrast, 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

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<sup>35</sup> National Council of State Housing Agencies, *2015 Housing Credit Q&A*, February 25, 2015.

<https://www.ncsha.org/resource/2015-housing-credit-qa>.

<sup>36</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>37</sup> *Ibid.*, p. 24.

<sup>38</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>39</sup> Harvard Joint Center for Housing Studies, "The State of the Nation's Housing 2013: Housing Challenges" (2013), available at [http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/son2013\\_chap6\\_housing\\_challenges.pdf](http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/son2013_chap6_housing_challenges.pdf).

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 effort to overhaul the nation's tax code. 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.

In terms of targeted improvements, Congress should, for example, make permanent the flat 9 percent tax credit permanent and extend the same treatment to the 4 percent tax credit for the acquisition of property. Because these rates float and are not fixed, their value can be significantly reduced, which, in turn, reduces the amount of resources available to finance affordable housing. Under current law, the 9 percent tax credit is, in April 2015, worth 7.48 percent while the 4 percent credit is valued at 3.21 percent. During the 113<sup>th</sup> Congress, Senators Cantwell and Roberts, joined by Finance Committee Senators Brown, Crapo, Cardin, Menendez, Rockefeller, Schumer, and Stabenow, introduced the *Improving the Low Income Housing Tax Credit Rate Act* (S. 1442) to make permanent the 9 percent rate for new construction and the 4 percent rate for acquisitions.<sup>40</sup>

Due to the significant support of Finance Committee senators, as well as House Ways and Means Committee members, Congress in December 2014 enacted the *Tax Increase Prevention Act of 2014* (P.L. 113-295) that extends the temporary fixed rate on the 9 percent tax credit for projects that received a LIHTC allocation prior to January 1, 2015. Unfortunately, despite the Finance Committee's approval of a proposal to extend the same treatment to the 4 percent credit for acquisitions in the Senate's version of the tax extenders bill, this provision was dropped in the final bill sent to President Obama.<sup>41</sup> To keep financing flowing for new construction and acquisitions, Congress should enact the provisions contained in S. 1442.

A second LIHTC area 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

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<sup>40</sup> S. 1442, *Improving the Low Income Housing Tax Credit Rate Act*, Section 2, Extension and Modification of Minimum Low-Income Housing Tax Credit Rate for Certain Buildings.

<sup>41</sup> S. 2260, *Expiring Provisions Improvement, Reform, and Efficiency (EXPIRE) Act of 2014* (as reported by the Senate Committee on Finance), Section 112, Extension and Modification of Temporary Minimum Low-Income Housing Tax Credit Rate for Non-Federally Subsidized Buildings.

whose *average* income is below 60 percent of AMI, it could serve a wider array of households. Notably, President Obama included a version of this proposal in his Fiscal Year 2016 Budget.<sup>42</sup>

### ***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 2015, there is a \$5.43 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.

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<sup>42</sup> Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals*, Reform and Expand the Low-Income Housing Tax Credit, Encourage mixed income occupancy by allowing LIHTC-supported projects to elect a criterion employing a restriction on average income, p. 69.

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

Enacted in 1980 to prevent foreign investors from harming family farmers by putting upward pressure on the price of U.S. farmland, 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, 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 required to suffer 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 deters foreign investment in U.S. real estate. First, the buyer of a property must withhold 10 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 due solely to 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 targeted reforms to the FIRPTA regime. NMHC/NAA are

particularly pleased that the Finance Committee on February 11, 2015, approved legislation offered by Senators Menendez and Enzi that would provide a partial exemption from FIRPTA for certain stock of real estate investment trusts.<sup>43</sup> Another worthwhile proposal would exempt from the application of FIRPTA gains of foreign pension funds from the disposition of U.S. real property interests. Notably, President Obama included a version of this proposal in his Fiscal Year 2016 Budget.<sup>44</sup>

### ***Priority 9: Improve Incentives for Energy Efficiency in Commercial Buildings and Large Multifamily Properties***

As the Finance Committee considers how the tax code could be used to facilitate national priorities in the energy sector, we wish to call your attention to the Energy Efficient Commercial Buildings Tax Deduction (Sec. 179D of the Internal Revenue Code of 1986) and the importance of this incentive in achieving improved environmental quality, reinforcing our national security, creating jobs in the construction and manufacturing sector and increasing housing affordability by decreasing utility expenses for millions of Americans who live in apartment homes.

We believe that Title I of the *Energy Efficiency Tax Incentives Act* (S. 2189), which was introduced in the 113th Congress by Finance Committee Senator Cardin, provides a responsible plan for enhancing the current Sec. 179D to assist property owners to make meaningful improvements in the energy performance of their properties.<sup>45</sup> Many older properties have been unable to fully utilize 179D, which we note was extended as part of the *Tax Increase Prevention Act of 2014* (P.L. 113-295) but once again expired at the end of 2014, because they have had difficulty in achieving the requisite 50 percent improvement in building energy performance over the level specified in the 2001 version of the American Society of Heating, Refrigerating and Air-Conditioning Engineers (ASHRAE) 90.1 code. While S. 2189 includes updated energy code references against which whole building performance will be measured for many properties, it also includes a pathway for older properties to qualify for incentives that will assist property owners in making building system upgrades that will yield significant energy savings.

Older building structures face technical limitations in achieving the energy performance metrics specified by the current code, let alone reaching the incremental “above-code” performance characteristics required to claim the 179D deduction. S. 2189 establishes a sliding scale of energy improvements, using the property’s current energy performance as the baseline. This pathway of significant improvement in energy performance relative to the property’s own baseline performance will provide a much-needed financial tool for property owners who want to make these types of investments but have not been able to do so.

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<sup>43</sup> Senate Finance Committee, An Original Bill Relating to Real Estate Investment Trusts (REITs), Regulated Investment Companies (RICs) and the Foreign Investment in Real Property Tax Act (FIRPTA), marked up by the Finance Committee on February 11, 2015.

<sup>44</sup> Department of the Treasury, *General Explanations of the Administration’s Fiscal Year 2016 Revenue Proposals*, Exempt Foreign Pension Funds from the Application of the Foreign Investment in Real Property Tax Act (FIRPTA), p. 91.

<sup>45</sup> S. 2189, *Energy Efficiency Tax Incentives Act*, Title I -- Commercial Building Modernization.

Advances in residential construction methods have improved the energy use profile of new buildings; however, the majority of the nation's building stock predates the use of highly energy efficient products and techniques. The U.S. Department of Energy (DOE) reports that housing built after 2000 used 14 percent less energy per square foot than housing built in the 1980s and 40 percent less than housing built before 1950.<sup>46</sup> As such, there is considerable room for improvement in energy performance even among well designed, constructed and maintained properties. A recent study conducted by CNT Energy and the American Council for an Energy-Efficient Economy finds that “[b]uilding owners often need financial incentives to adopt new technologies or equipment with higher upfront costs. Despite this, studies have documented that affordable housing, often multifamily, receives a disproportionately small share of available energy efficiency funding.”<sup>47</sup>

According to the American Housing Survey (2009), almost 81 percent of the nation's stock of apartment properties (with 5 or more units) was constructed prior to 1990, which marks the decade in which the first building energy codes were implemented. This older stock of housing, which is an important source of affordable housing, represents a significant opportunity for achieving energy savings while at the same time adding to the available spending capacity of individuals who live in these apartment homes. This is a significant consideration given that in 2010 approximately 70 percent of renter households had incomes below the national median and more than 40 percent had incomes in the bottom quartile.<sup>48</sup> Furthermore, “energy costs as a share of gross rents rose from 10.8 percent to 15.0 percent between 2001 and 2009. Lowest income renters saw the largest increase in their utility share, a jump from 12.7 percent to 17.4 percent.”<sup>49</sup>

There is a direct relationship between the age of a residential building and energy expenditures. The per-square-foot energy costs of housing constructed from 1980 to 1989 is 16 percent higher than that of a building constructed after 2000. Those expenditures soar to a 28 percent increase in residential buildings built between 1970 and 1979 over post-2000 properties.<sup>50</sup> Energy efficiency in multifamily properties could be economically improved by 30 percent with a savings of \$9 billion in averted energy costs not to mention the substantial savings in greenhouse gas emissions.<sup>51</sup>

NMHC/NAA believe that a sound national tax policy can be used to catalyze a market transformation marked by significant improvements in building energy performance. A meaningful and predictable tax incentive would leverage private investment in qualified building

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<sup>46</sup> U.S. Department of Energy, 2011 Buildings Energy Data Book. March 2012. Chapter 2.

<sup>47</sup> CNT Energy and American Council for an Energy-Efficient Economy, *Engaging as Partners in Energy Efficiency: Multifamily Housing and Utilities*. January 2012. <http://www.cntenergy.org/media/Engaging-as-Partners-in-Energy-Efficiency-MF-Housing-and-Utilities-Final-012512.pdf>. p.4.

<sup>48</sup> Joint Center for Housing Studies of Harvard University, *America's Rental Housing-Meeting Challenges, Building on Opportunities*. 2011. p. 17 <http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/americasrentalhousing-2011.pdf>; U.S. median household income fell from \$51,144 in 2010 to \$50,502 in 2011 according to the *United States Census, American Community Survey Briefs*, September 2012, Appendix Table 1, p. 5.

<sup>49</sup> *Ibid.*

<sup>50</sup> U.S. Department of Energy, *supra* note 1, at p. 2-20 derived from Table 2.3.12.

<sup>51</sup> Joint Center for Housing Studies of Harvard University, *supra* note 2, at p.33.

retrofits and would have a positive effect on the economy as it would result in increased demand for construction services, materials and equipment.

## Conclusion

In closing, NMHC/NAA look forward to working with the Senate 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.

Sincerely,



Douglas M. Bibby  
President  
National Multi Housing Council



Douglas S. Culkin, CAE  
President  
National Apartment Association