January 16, 2014

The Honorable Max Baucus
Chairman
Senate Committee on Finance
215 Dirksen Senate Building
Washington, DC 20510

Dear Mr. Chairman:

Thank you for the opportunity to comment on the proposed reforms to cost recovery and tax accounting rules included in the Senate Finance Committee staff discussion draft released on November 21, 2013 (the "**Finance Discussion Draft**").

We applaud your objective of creating a modern, simpler, and fairer tax system and your desire to use tax reform as a way to jumpstart economic growth. The proposals put forward in the Finance Discussion Draft, however, would neither promote tax neutrality with respect to real property, nor stimulate job growth in the real estate sector, which contributes nearly one-fifth of our nation's gross domestic product. On the contrary, if enacted in their current form, the proposals threaten a key engine of the economic recovery, real estate activity and investment.

The Finance Discussion Draft contains substantial and radical tax increases on real estate ownership, many of which are retroactive because they would apply to existing investments. The draft would extend the tax recovery period for virtually all real property to 43 years (a period well beyond economic life), raise the tax rate on recaptured depreciation, and repeal like-kind exchange rules that taxpayers have relied on for nearly 100 years. And in a major departure from the historic norm in which legislative changes to cost recovery rules are only applied prospectively, the draft would impose the tax increases on existing investment. Collectively, the proposals in the Finance Discussion Draft could have a severe, widespread, and chilling effect on U.S. real estate activity. By creating an arbitrary and discriminatory cost recovery system that is detached from the economic life of actual structures, the proposals would reduce real estate investment and development, result in lower real estate values, and stifle the real estate industry's ability to continue creating new jobs just as the economic recovery shows signs of picking up steam.

In many respects, the changes proposed in the Finance Discussion Draft are more sweeping and fundamental than the provisions enacted as part of the Tax Reform Act of 1986. The principal real estate reform, the passive loss limitations, was retroactive as well, and together with other changes resulted in a real estate industry depression and led the way to the recession of the early 1990s. The 1986 Act was aimed at ending abusive tax sheltering activity and reforming accelerated depreciation rules that created uneconomic incentives to own and invest in real estate. In contrast, proposals in the Finance Discussion Draft would decouple the tax system from the underlying economics of real estate ownership. The draft would impose punitive and targeted tax increases on economically sound investment in commercial real estate under the false pretext of a "simpler and fairer" cost recovery system.

By applying the new rules retroactively, the Finance Discussion Draft would penalize people who relied on well-established tax rules when committing their capital and sweat equity to a long-term investment. Much like the 1986 Act, the Draft would pull the rug out from under

taxpayers in a way that would be fundamentally unfair, undermines confidence in the stability of our tax and regulatory system, and raises legitimate doubts about future "rules of the road" for capital-intensive property investments.

In addition, the Finance Discussion Draft repeals a tax provision, the section 179D energy-efficient commercial buildings deduction, which is needed to address a failure of the market to accurately take into account the value of energy-efficiency improvements to commercial buildings.

The potential consequences of the Finance Discussion Draft are far-reaching. Pension plans and life insurance companies, which provide retirement and income security to millions of working Americans and retirees, could suffer as their real estate investments lose value. Local governments, which rely on property taxes to finance basic services, such as law enforcement and schools, would lose revenue as property values decline. Jobs otherwise created when real estate is developed or improved would languish because the punitive tax rules will have made real estate a less attractive investment option.

In short, we cannot support proposals that would:

- Distort investment decisions by substantially and retroactively limiting depreciation deductions for all real property, regardless of when the property was acquired; and

- Lock-in existing ownership arrangements and cripple economic activity in the commercial real estate market by (a) repealing the 90-year old statutory authority to do like-kind real estate exchanges[1] and (b) retroactively recapturing all depreciation on real property sales at ordinary income rates.

The sweeping nature of the Finance Discussion Draft and its impact on the real estate industry, as well as its potential consequences for our accelerating economic recovery, should be fully understood prior to any further action. The proposed changes are analyzed in greater detail below.

DISCUSSION

I. Real Estate and Pro-Growth Tax Reform

Real estate reaches into every American community. From single-family and apartment homes to office buildings and hospitals, from warehouses and shopping malls to farmland, other investment land, industrial properties, and hotels, real estate touches our economy and our national life in a way that is real and tangible. Real estate is where America lives, works, shops, plays, and invests.

Commercial real estate's contribution to the nation's economy is enormous. The total value of America's commercial real estate is approximately $5.26 trillion,[2] leveraged conservatively at

[1] We also oppose any attempt to impose a similar-use requirement to qualify for like-kind exchanges because it would prevent the free flow of investment between different types of investment real estate.

[2] Estimate of the Research Committee of The Real Estate Roundtable.

less than 60 percent ($2.11 trillion of equity and $3.15 trillion of debt[3]). Large and small commercial banks hold approximately $1.5 trillion of commercial real estate mortgages on their balance sheets, while life insurance companies and pension funds hold an additional $350 billion of commercial real estate mortgages.[4] The commercial mortgage-backed securities (CMBS) market is over $560 billion; the government sponsored enterprises and government hold approximately $427 billion; agency mortgage-backed securities account for $139 billion; mortgage REITs and other sources add $173 billion.[5]

Real estate activity accounts for nearly one-quarter of taxes collected at all levels of government (this includes income, property, and sales taxes). Taxes derived from real estate ownership and transfer represent the largest source —over 70 percent— of local tax revenues, helping to pay for schools, roads, law enforcement, and other essential public services.[6] Real estate provides a safe and stable investment for individuals across the country, notably retirees. Over $350 billion is invested in real estate and real estate-backed investments by tax-exempt organizations (*e.g.*, pension funds, foundations, educational endowments and charities).[7]

Our industry is one of the leading employers in the United States. Real estate companies and professionals engage in a broad array of activities that generate millions of real estate-related jobs, including those in construction, planning, architecture, building maintenance, management, environmental consulting, leasing, brokerage, mortgage lending, accounting and legal services, investment advising, and interior design.

Real estate assets and investment drive gains in economic productivity. The output of any economic activity is a product of the space in which it is created. By its very nature, as the place in which goods and services are produced, real estate makes other types of productivity possible. Optimizing the location, configuration, and architecture of a business's physical structures contributes directly to the productivity and efficiency of an enterprise and its workers. The functionality and needs of industrial, office, retail, and multifamily residential buildings are constantly changing as markets and ways of doing business transform. The tax code should not shackle real estate with cost recovery rules that fail to recognize the rapid rate of economic change.

While real estate activity has played a large role in leading the country out of the deepest recession since the 1930s, there is much more real estate can do to accelerate broad-based economic growth and job creation. We recognize the need for fundamental tax reform. Excessive

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[3] The debt statistic is from the Federal Reserve's Flow of Funds Report and includes all commercial real estate sectors, including multifamily residential properties. *See* Board of Governors of the Federal Reserve, *Financial Accounts of the United States: Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts*, *Third Quarter 2013*, at 104-05 (Dec. 9, 2013).

[4] *Id*.

[5] *Id.*

[6] U.S. Census Bureau, *State Government Tax Collections Summary Report: 2012*, at 4 (Apr. 11, 2013), *available at*: http://www2.census.gov/govs/statetax/2012stcreport.pdf.

[7] Institutional Real Estate, Inc., *Tax-Exempt Real Estate 2013: Annual Plan Sponsor Survey* (2013), *available at:* http://www.ncreif.org/download.aspx?file=2013_Plan_Sponsor_Survey.pdf.

tax complexity is an artificial and unnecessary burden that can suffocate businesses, and especially the small, family-owned businesses that are the lifeblood of real estate activity.

In the past, tax legislation and cost recovery reforms have contributed to economically unsustainable real estate bubbles by artificially stimulating investment. For example, the Economic Recovery Tax Act of 1981 reduced the recovery period for real property to 15 years, far shorter than justified by the economic life of most structures.[8] Similarly, past legislative efforts to rein in perceived abuses in real estate markets have overshot their objective and had severe, unintended consequences. The retroactive application of passive loss rules in the Tax Reform Act of 1986, for example, led to the crash of the commercial real estate market in the late 1980s, bank runs, and the taxpayer bailout of saving and loan institutions. Successful tax reform is contingent on avoiding a repeat of these prior mistakes.

With the right tax and regulatory policies, real estate could create millions of new, middle-class jobs here in the United States while also contributing to a more efficient and productive domestic economy and workforce. Tax reform could act as a catalyst for real estate activity by treating the industry consistently with other types of businesses and assuring predictability for long-term investment. The reformed tax code should be simpler than today's system, but also encourage capital formation, and avoid the excessive incentives or disincentives that can distort the flow of capital investment. Cost recovery rules, for instance, should be grounded in a careful understanding of the economically useful life of structures in the 21st century. And reform should provide for a reasonable transition regime that minimizes dislocation in real estate markets.

II. Finance Discussion Draft: Raise Taxes on Real Property by Lengthening Cost Recovery Periods on New and Prior Real Estate Investment

The Finance Discussion Draft proposes a fundamental overhaul of the current cost recovery system. The draft would create an asset pooling system for personal property while preserving rules in which real estate is depreciated using the straight-line method on an individual, asset-by-asset basis. The draft consolidates the depreciation schedules for different types of real estate into one recovery period for all real property. According to summary documents released with the draft, the proposal seeks to create a cost recovery system "that better approximates the decline in the economic value of assets."[9]

Under the proposal, all real property would be depreciated on a straight-line basis over 43 years. The Finance Committee staff instructed the Congressional Budget Office (CBO) to calculate a straight line recovery period with a present value equal to the economic rate of decline. The draft would eliminate the current, distinct recovery periods that apply to leasehold improvements (15-year life), residential rental property (27.5-year life), and nonresidential property

[8] In 1981, Congress was explicit in its desire to boost investment by accelerating the cost recovery of new investment, "prior law rules for determining depreciation allowances . . . needed to be replaced because they did not provide the investment stimulus that was felt to be essential for economic expansion." Joint Committee on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981*, at 75. Congress adopted rules in the Economic Recovery Tax Act of 1981 that allowed taxpayers to deduct real property investment over a 15-year period using an accelerated 175-percent declining balance method, switching to the straight line method when it would maximize the recovery allowance. *Id.*

[9] Summary of Staff Discussion Draft: Cost Recovery and Accounting, p. 5 (Nov. 21, 2013).

(39-year life). The extended recovery period would apply retroactively to real property, regardless of when it was placed in service. Under the draft's transition rule, the remaining depreciable life of existing investments would be extended to ensure that the asset is recovered over a full, 43-year period.[10]

Separately, the proposal would reclassify land improvements—such as sidewalks, driveways, parking lots, lighting, and fences—as property with a 20-year life for purposes of the new pooled asset recovery system, in contrast to the current 15-year life.

A. Economic Neutrality Requires Shortening, not Lengthening, the Cost Recovery Period for Real Property

The most recent academic and government research, including the federal government's own studies, suggest: (a) the economic rate of depreciation of real property is much faster than previously estimated and (b) the recovery period for real property should be shorter, not longer, than it is today. A close review of the data behind the 43-year recovery period in the Finance Discussion Draft reveals outdated sources that give rise to misleading conclusions.

1. <u>The Finance Discussion Draft depreciation estimates rely on outdated studies from the 1960s and 1970s that fail to account for economic and policy changes</u>

The underlying depreciation estimates used by staff to arrive at a 43-year recovery period for real property are 40 years to 50 years old. They are not credible sources for the formulation of tax policy in a modern economy. 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.[11] These old studies have outlived their usefulness, rely on vastly different input costs and user needs, and should not guide current policymaking.

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[10] For example, an apartment building placed in service in 1994 could have 7.5 years remaining in its 27.5-year depreciable life. The Finance Discussion Draft would add 15.5 years to the 27.5 year life of the building (in order to bring it to a full 43-year recovery period). Thus, the remaining basis of the building would be depreciated over a 23-year period (7.5 years + 15.5 years), and the annual deductions would be reduced to less than one-third of the current depreciation deductions.

[11] A letter released by CBO on the same day as the release of the Finance Discussion Draft 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." *See* Letter from CBO Director Douglas W. Elmendorf to Chairman Max Baucus, *Information on the Depreciation of Assets* (Nov. 21, 2013), *available at:* 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/Tablecandtext.pdf)." *Id.* at 9.

Review of the BEA Depreciation Estimates reveals the reliance on studies from the 1960s and 1970s to determine the economic rate of depreciation for real property. With regard to nonresidential property, the BEA study states: "Private nonresidential structures. . . .For other types of nonfarm structures, service lives are based on published and unpublished data from studies conducted during the 1960s and 1970s by the U.S. Department of the Treasury.[6]" The accompanying footnote cites the following: U.S. Department of the Treasury, Office of Industrial Economics, Business Building Statistics (Washington, D.C.; U.S. Government Printing Office, Aug. 1975). *See* BEA Depreciation Estimates, at 3. With regard to

The depreciation estimates underlying the Finance Discussion Draft do not reflect recent trends and changes in building design, and they also fail to account for macroeconomic changes since the 1960s. Intervening changes include the movement from structures serving industrial production to those for a service-oriented economy. They also include an increase in apartment living by households of all incomes and demographics, as opposed to mostly lower-income and public housing residents. Moreover, the studies were conducted when the tax law allowed for component depreciation—building components were separated from the building shell and depreciated on a shorter schedule—which further skews their relevance to current rules requiring composite depreciation of structures.

2. In the 21st century, real property depreciates at an increasingly rapid pace.

Economic depreciation refers to the decline in the value of an asset as it ages. It measures not just physical wear and tear, but also adjustments to the relative price of an asset caused by changes in tastes and by improvements in the quality of new assets relative to old assets.[12] This second factor – referred to as obsolescence – is critical when measuring the rate of economic depreciation. In the case of real property, research has shown that obsolescence weighs more heavily on the rate of economic depreciation than physical deterioration.[13]

a. *Obsolescence accelerates the depreciation of real property.*

The obsolescence, and therefore the rate of economic depreciation, of real property is accelerated by a number of aesthetic, functional, and legal factors. These can include: (1) an outdated appearance relative to an occupier's expectations, (2) technological progress that changes occupiers' requirements related to a building's layout and facilities, and (3) new building standards and regulations. More specifically, a structure's external appearance, entrance hall, and common areas can become quickly obsolete as market perceptions of design quality change. Functional needs related to a building's layout, configuration, ceiling height, and quality of services (*e.g.*, elevators, wiring, and HVAC) also change rapidly. Legal developments related to building standards, health safety regulations, and energy requirements also weigh on a property's value and increase the rate of depreciation.

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residential rental property, the BEA study states: "*Residential structures*. The average service lives for most types of new residential structures are taken from a study by Goldsmith and Lipsey.[7] Improvements to residential structures are assigned the following lives: Additions and alterations are assumed to have lives one-half as long as those for new structures; and lives for residential major replacements are based on industry estimates for items replaced during the 1970s." The accompanying footnote refers to: Raymond W. Goldsmith and Robert Lipsey, *Studies in the National Balance Sheet of the United States*, Volume 1 (Princeton, NJ: Princeton University Press, for the National Bureau of Economic Research, 1963). *See* BEA Depreciation Estimates, at 4.

[12] *See* Clinton Admin. Treasury Depreciation Study, at 5.

[13] *See* Andrew E. Baum, *Quality, Depreciation, and Property Performance*, THE JOURNAL OF REAL ESTATE RESEARCH (Fall 1993).

b. *A broad consensus of economists, academics, and government officials agree that real property depreciates faster than recognized under current tax law.*

Independent and objective analyses consistently find that structures economically depreciate faster than the tax rules for cost recovery permit. A comprehensive report on depreciation recovery periods and methods undertaken by the Treasury Department during the Clinton Administration (and mandated by the Congress) concluded that a 30-year straight-line depreciation schedule for nonresidential real property would match the economic rate of depreciation, not the current 39-year rule.[14] Separately, a study by economists in Treasury's Office of Tax Analysis found that a 20-year recovery period for nonresidential property would be needed to provide tax parity with equipment.[15]

Research by Deloitte in 2000 found that the straight-line depreciation schedule for structures that would correspond to the economic rate of depreciation would range from 18 years for retail property to 23 years for residential rental property.[16] A 2005 study on the economic rate of depreciation for multifamily property by researchers from Indiana University and Virginia Commonwealth University found that the appropriate straight-line recovery period would be 26 years if a long-term inflation rate of three percent is assumed.[17] The punitive nature of current depreciation methods and schedules has led Dr. Jane Gravelle of the nonpartisan Congressional Research Service (CRS) to identify the tax depreciation rules that apply to real property as the greatest single economic distortion in our tax system.[18]

3. <u>The proposal relies on short-term inflation assumptions that further understate the rate of economic depreciation.</u>

Because depreciation deductions are based on an asset's original cost, inflation that occurs after an asset is purchased reduces the real value of the asset's subsequent depreciation deductions.[19] Understating the rate of inflation when setting depreciation schedules reduces the

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[14] Clinton Admin. Treasury Depreciation Study, at 89 ("Assuming straight-line depreciation, a 30-year recovery period would give nonresidential structures about the same marginal effective tax rate as implied by estimates of economic depreciation.").

[15] David W. Brazell & James B. Mackie, Office of Tax Analysis, U.S. Department of the Treasury, *Depreciation Lives and Methods: Current Issues in the U.S. Capital Cost Recovery System*, NATIONAL TAX JOURNAL (Sept. 2000) ("Because of relatively slow depreciation allowances, on average nonresidential buildings face a 39.0 percent marginal effective tax rate, well above the average marginal effective tax rate for the corporate sector as a whole and above the marginal effective tax rate implied by economic depreciation.").

[16] Deloitte & Touche LLP, *Analysis of the Economic and Tax Depreciation of Structures* (June 2000).

[17] Jeffrey D. Fisher et al, *Analysis of Economic Depreciation for Multi-Family* Property, The Journal of Real Estate Research (Oct. 2005).

[18] Jane G. Gravelle, *Whither Tax Depreciation?*, NATIONAL TAX JOURNAL (Sept. 2001), at 525 ("There is, as noted earlier, good reason to believe that the largest existing distortion in the tax system is the extremely long lives and slow methods of depreciation for buildings, particularly non–residential buildings.").

[19] *See* Alan J. Auerbach, *The New Economics of Accelerated Depreciation*, NBER Working Paper No. 848 (Jan. 1982), at 21 ("Under any capital recovery system where depreciation allowances are based on original cost, the effect of inflation is to lower the real value of future depreciation allowances.").

incentive to invest. Although the discussion draft attempts to take into account the effect that inflation has on the depreciation of assets, the proposal uses an inflation adjustment, 2.18 percent, that is less than CBO's own long-term inflation projection of 2.5 percent. The 2.18 percent inflation adjustment came from CBO's February 2013 ten-year economic projections. More recent, long-term economic projections released by CBO in August project a long-term rate of inflation of 2.5 percent. The long-term projection is a more appropriate estimate for long-lived assets. Using the Committee's own methodology, the higher inflation rate assumption would result in a shorter recovery period for real property.[20]

B. By Cutting Depreciation Deductions, the Finance Discussion Draft Raises the Tax Rate on Real Estate Investment

1. The proposal reduces annual depreciation deductions by more than 65 percent for leasehold improvements, 35 percent for residential rental property, and nearly 10 percent for nonresidential property.

Relying on the inaccurate data described above, the proposal would severely reduce depreciation deductions, particularly for residential rental property and leasehold improvements. By extending the straight-line recovery period for residential rental property from 27.5 years to 43 years, the proposal would reduce the annual depreciation deduction for the owners of residential property by a minimum of 36 percent. Extending the recovery period for leasehold improvements from 15 years to 43 years, decreases the annual depreciation deductions for leasehold improvements by at least 65 percent. In the case of nonresidential property, annual depreciation deductions would be reduced by a minimum of nearly 10 percent. In all three cases, under the transition rule, the reductions would be even larger if the property is closer to the end of the recovery period. As a consequence, the proposed tax increase would hit older investments the hardest. The net effect of reducing depreciation deductions is to raise the effective tax rate on real property investment.

2. Extending the depreciation period on residential rental property would harm the apartment industry's ability to provide shelter to millions of Americans.

Today, there are over 19 million apartments (buildings with five or more units) in the U.S. that, taken together, provide a place to live for 36.4 million residents. Moreover, demand for apartments continues to grow. In this decade, renters could make up half of all new households. Unfortunately, supply is already falling short of meeting this demand. Just 158,000 apartments were built in 2012, well short of the estimated 300,000 to 400,000 needed to keep up with demand each year. Finally, the shortage is particularly acute for low- and moderate-income households, as the Harvard Joint Center for Housing Studies estimates a nationwide affordable housing shortfall of 5.3 million units.

3. Slowing depreciation of leasehold improvements would penalize building owners and discourage property upgrades, to the detriment of small businesses.

[20] Particularly in the case of property depreciated on a straight-line basis, a higher inflation assumption dictates a shorter recovery period. Otherwise, as the nominal value of assets rise, the real value of the depreciation deduction will decline at a faster rate than is appropriate for measuring economic income.

Leasehold improvements, sometimes referred to as "build-outs", are the structural changes made to leased space to make it suitable for a tenant's specific business needs. They can include, lighting changes, technology upgrades, special rooms or partitions, or a security system, to name just a few. Leasehold improvements typically last for 5-10 years or less as the needs of new or existing commercial tenants change. In 2004, Congress recognized the unrealistic and uneconomic treatment of depreciating leasehold improvements over 39 years and provided a temporary 15-year recovery period for qualified improvements.[21] The provision has been extended on several occasions. As recently as 2012, the Finance Committee expressly recognized the need for a significantly shorter depreciation period for leasehold improvements.[22] The discussion draft's proposal to extend the recovery period for leasehold improvements from 15 years to 43 years would require owners to recover the cost of these investments over a period that is more than four times longer than the average life of the actual improvement.

The proposal would exacerbate the current mismatch of revenue to expense for leasehold improvements, increase their tax cost, and create an economic disincentive for owners to improve older buildings and contribute to community revitalization efforts. The impact of the proposal would hit small businesses the hardest. Small businesses turn over real estate space more frequently than larger businesses. They grow and expand their operations at a faster pace and are much more likely to demand new and revised work space. A rational tax policy would tie the depreciation of leasehold improvements to the life of the lease, or a period that approximates average lease terms. Consistent with the Chairman's objective of matching depreciation with economic life, this reform would stimulate improvements that allow tenants to operate more efficiently and profitably, and would spur job creation for construction, electrical, plumbing, and other typically small business trade workers.

4. <u>The proposals would exacerbate the inequities of current cost recovery rules</u>.

The existing depreciation regime is far less favorable for real property investment than at any time in recent history. In the case of commercial real estate, current-law depreciation recovery periods and methods generate deductions that are smaller in terms of their present value than any time since 1954.[23] And in the case of residential rental property, the present value of depreciation

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[21] American Jobs Creation Act of 2004, Pub. L. No. 108-357 § 211 (2004), codified in I.R.C. § 168(e)(3)(E)(iv). *See also* Joint Committee on Taxation, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 108TH CONGRESS (2007), at 180-82 ("The Congress believed that taxpayers should not be required to recover the costs of certain leasehold improvements beyond the useful life of the investment. The 39-year recovery period for leasehold improvements extends well beyond the useful life of such investments."). Leasehold improvements have also qualified for temporary bonus depreciation benefits.

[22] Family and Business Tax Cut Certainty Act of 2012, Sen. Rept. No. 112-208 (2012), at 45:

> The 39-year recovery period for lease-hold improvements for property placed in service after December 31, 2007, extends beyond the useful life of many such investments. Although lease terms differ, the Committee believes that lease terms for commercial real estate are also typically shorter than the 39-year recovery period. In the interests of simplicity and administrability, a uniform period for recovery of leasehold improvements is desirable.

[23] Jane G. Gravelle, *Depreciation and the Taxation of Real Estate*, CRS Report for Congress, at 2 (May 12, 1999).

deductions is smaller than at any time since 1971.[24] The result is that current depreciation rules favor investment in equipment and machinery over real property.[25] Recent research by Dr. Gravelle has demonstrated how lower effective tax rates on equipment and machinery relative to the effective tax rate on real estate lead to an inefficient allocation of investment capital.[26] She concluded that slowing depreciation as a way to broaden the tax base would increase the effective tax rate on capital and lead capital to leave the United States, the opposite of what proponents profess to achieve.[27]

III. Finance Discussion Draft Proposal: Repeal Deferral of Gain on Like-Kind Exchanges of Real Property

The Finance Discussion Draft would reduce the incentive to acquire, develop, own, and improve real property by repealing Section 1031 of the tax code and taxpayers' ability to defer capital gain when disposing of real property held for use in a trade or business, or held for investment, if the property is exchanged for property of a "like-kind." The change would apply to transactions after December 31, 2014, regardless of when the initial real estate investment was made.

A. Deferral of gain on like-kind exchanges is a bedrock principle of our tax policy and nearly as old as the income tax itself.

From almost its inception, the tax system has recognized that when an investor in real estate exchanges one property for another of like kind, economically, nothing has changed.[28] The

[24] *Id.*

[25] *See id.* At 10-11 ("[W]hile equipment had a somewhat more favorable treatment in 1986 than structures, the gap between the two has widened. . . . If effective tax rates on structures were to be brought into line with those on equipment, one could either raise the tax burden on equipment by lengthening lives or lower the tax rate on structures by shortening lives.")

[26] Jane. G. Gravelle, *Reducing Depreciation Allowances to Finance a Lower Corporate Tax Rate*, NATIONAL TAX JOURNAL (Dec. 2011). According to Dr. Gravelle, "[M]ost equipment assets are taxed at effective tax rates that are below the statutory rate. The effective tax rates range from 17 percent to 36 percent, but the majority of assets are taxed at effective rates below 30 percent. . . . Buildings, in general, are taxed at or above statutory rates." *Id.* at 1042. The only exceptions in which structures are taxed at a lower effective tax rate than the statutory rate, according to Dr. Gravelle, are in the case of public utilities, farm structures, and mining structures—generally oil and gas-related. *Id.*

[27] *Id*. at 1052.

[28] The Revenue Act of 1921 provided in general that no gain or loss was recognized on an exchange of business or investment property for property "of a like kind or use," even if the property received had "a readily realizable market value." Pub. L. No. 67-98, § 202, 42 Stat. 227, 230 (1921). Even before the first statutory rules for capital gains were written, earlier tax regulations introduced the non-recognition principle for like-kind property:

> Gain or loss arising from the acquisition and subsequent disposition of property is realized when as the result of a transaction between the owner and another person the property is converted into cash or into property (a) that is essentially different from the property disposed of and (b) that has market value. In other words, both (a) a change in substance

text of the like-kind exchange rule survived the base-broadening reforms of 1986. With the exception of a 1984 law that disallowed tax-deferred exchanges involving partnership interests and imposed tighter rules related to the timing of exchanges, Congress has largely left the like-kind exchange rules unchanged since 1924.[29] The deferral benefit for like-kind exchanges is limited and does not extend to investments that are liquid, readily convertible to cash, and easy to value, such as stocks, bonds, notes, securities, and inventory.[30] Instead, the like-kind exchange rules place the taxpayer who has exchanged illiquid property such as real estate for other property of a like-kind into a nearly identical position to the holder of an asset that has appreciated or depreciated in value, but who has not yet exited his investment. And under longstanding tax policy, the mere appreciation or depreciation of an asset, without recognition of the gain or loss, almost never triggers a taxable event.[31]

B. The roll-over of gain on like-kind exchanges ensures a well-functioning, dynamic, and efficient U.S. real estate market.

Delaying gain recognition until a real estate investment is "cashed out" constitutes sound tax and economic policy. Allowing capital to flow more freely among investments is critical to facilitate commerce and support economic growth and job creation. The like-kind exchange provision allows taxpayers to shift resources to more productive but similar property, change geographic location, diversify or consolidate holdings, or otherwise transition to meet changes in business needs. Like-kind exchanges are particularly critical to the efficient functioning of the large and highly illiquid market for commercial and residential rental property, where the asset is capital-intensive, long-lived, and past depreciation deductions greatly increase the tax burden associated with transferring ownership. The deferral of gain allows individual owners and families to transfer property into the hands of active owners who can invest the capital necessary to ensure the property is put to its best use. Otherwise, property in need of capital investment will remain in the hands of owners who are deterred for tax reasons from transferring the asset. By helping to get property into the right hands, rather than locking it up to defer tax indefinitely, the like-kind exchange rules facilitate job-creating property upgrades and improvements.

> and not merely in form, and (b) a change into the equivalent of cash, are required to complete or close a transaction from which income may be realized.

Treas. Reg. 45, art. 1563, *reprinted in* 2 C.B. 38 (1920) (issued under the authority of the Revenue Act of 1918).

[29] The Deficit Reduction Act of 1984 restricted deferral treatment for exchanges of partnership interests and required taxpayers to identify like-kind property within 45 days and to complete the exchanges within 180 days. Pub. L. No. 98-369, § 77 (1984). Other minor changes to the like-kind exchange rules since 1924 relate to exchanges between related parties and exchanges between domestic-use and foreign-use property. Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, § 7601, 103 Stat. 2301, 2370-71 (1989); Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1052, 111 Stat. 788, 940 (1997).

[30] I.R.C. § 1031(a)(2).

[31] Section 1256, which requires end-of-year valuation of regulated futures contracts, is an uncommon exception that proves the rule.

C. Like-kind exchanges generate tax revenue for federal, state, and local governments and facilitate land conservation efforts.

Notwithstanding the deferral of gain under section 1031, like-kind exchanges of real property still generate significant federal tax revenue through the taxation of "boot," the money or other non-qualifying property that is included in the exchange to equalize the values of the properties that change hands.[32] The receipt of boot is taxable to the extent there is capital gain on the exchange. In addition, the receipt of boot can trigger tax through the recapture of depreciation. And because the deferral of gain in a like-kind exchange reduces the taxpayer's basis in the newly acquired property, like-kind exchanges result in smaller depreciation deductions for the taxpayer going forward.

Like-kind exchanges of real estate also generate significant revenue for state and local governments through conveyance, transfer, and recording taxes that are unrelated to the deferral of capital gain. Rather than generating revenue, ending deferral for like-kind exchanges of real property would likely have a chilling effect on real estate transactions, reducing the state and local revenue that flows from transaction activity.

Local governments and nongovernmental organizations frequently use like-kind exchanges to facilitate land conservation efforts. A common mechanism involves the transfer of one property in exchange for a land conservation easement on another property. The transaction receives like-kind exchange treatment.[33] The owner of the property subject to the new conservation easement agrees to restrict the use or development of the land. Conservation easements can be used to maintain wildlife habitats, protect scenic vistas and overlooks, improve water quality, and a variety of other purposes that benefit society and contribute to a sustainable environment.

D. The Finance Discussion Draft discriminates against real estate by expanding the deferral of gain for personal property while eliminating it for real property.

The discussion draft would establish a cost recovery regime that provides for tax deferral of gain on dispositions of personal property used in a trade or business, or for the production of income. The proposed pooled asset recovery system includes an inherent tax deferral mechanism that applies when personal property is sold as long as the taxpayer's pool balance (adjusted basis of assets in the pool at the end of the year) has not declined below zero. Thus, with respect to tangible property, taxpayers could offset the proceeds from the disposition of an asset with the basis of newly acquired assets, regardless of whether they are of a like kind (they only need to have the same pool classification). The liberal deferral rule for personal property, coupled with the full repeal of deferral for like-kind exchanges of real property would further distort investment decisions and increase the misallocation of capital in the economy. The effect is particularly damaging since like-kind exchange treatment is needed most of all in the real estate sector, where properties are highly illiquid and unlikely to change hands without the ability to defer gain.

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[32] Gerald J. Robinson, FEDERAL INCOME TAXATION OF REAL ESTATE § 12.04 (6th ed. 2007).

[33] *See, e.g.,* IRS Private Letter Ruling 9621012 (Feb. 16, 1996) (ruling that an exchange of a scenic conservation easement for a fee interest in timberland, farm land, or ranch land qualifies as a like-kind exchange under section 1031).

E. Substituting a "similar use" concept for like-kind exchange rules would violate tax neutrality and weaken the real estate market.

The staff summary requests comments on whether the rules should be revised to require a "similar use" concept, such as in the involuntary conversion rules. Adopting a stricter standard for real property exchanges at the same time that Congress is enacting a liberalized deferral rule for personal property would be counterproductive and undermine the objective of tax reform. It would move the tax code further away from tax neutrality for different types of capital investment. Moreover, a "similar use" rule would reduce liquidity in the real estate market, make real estate development more costly, and reduce the likelihood that real property will undergo the improvements and upgrades that often occur when new owners take over the property.

IV. Finance Discussion Draft Proposal: Raise the Tax Rate on Recaptured Depreciation

The Finance Discussion Draft would raise the tax rate that applies to a portion of the gain from the sale of depreciable real property. Gain from the sale of real property used in a trade or business or held for investment, is taxed as capital gain and, if sold by an individual, taxed at a maximum rate of 20 percent, provided it is held for at least one year. The portion of gain attributable to prior depreciation deductions, however, is generally taxed as long-term capital gain at a special rate of 25 percent.[34] This rule is commonly referred to as "depreciation recapture." The draft would repeal the 25 percent rate and tax all gain attributable to prior depreciation as ordinary income, effectively reducing the incentive to invest in real estate. Similar to the like-kind exchange provision, these changes would apply to transactions after December 31, 2014, regardless of when the initial real estate investment was made.

A. The proposal would discourage real estate investment by raising the tax rate on recaptured depreciation by nearly 60 percent.

The reduced 25 percent rate applicable to so-called depreciation "recapture" is an appropriate policy that recognizes the hybrid nature of real estate gains, which can derive from a combination of factors, including land appreciation, inflation, and the value of the owner's improvements to the property. The discussion draft would raise the tax rate that applies to recaptured depreciation to a maximum rate of 39.6 percent—a tax increase of nearly 60 percent. By increasing the tax that is imposed on a significant share of the profit from a real estate investment, the proposal would alter the economics of real estate transactions and deter new investment by lowering the projected after-tax rate of return on any given project.

[34] A portion of prior depreciation deductions may be currently taxable at ordinary income rates if the taxpayer used a cost recovery method that generated depreciation deductions in excess of straight-line depreciation. I.R.C § 1250. Because straight-line depreciation has been required for real property since the Tax Reform Act of 1986, and was commonly elected by the owners of nonresidential real property prior to 1986, the amount of gain subject to recapture under section 1250 is minimal.

B. The depreciation recapture proposal is a blunt, retroactive, and poorly designed tax increase that would reverse longstanding Congressional intent regarding the taxation of real estate ownership.

Congress has historically recognized that full depreciation recapture would disproportionately penalize real property investment. The rationale for the original depreciation recapture rule, section 1245, was to prevent taxpayers from using accelerated depreciation methods and recovery periods to convert ordinary income into capital gain.[35] The depreciation recapture regime was enacted in large part to offset a liberalization of depreciation methods, the opposite of what the discussion draft proposes.[36] Section 1245 generally excluded buildings and their structural components. Congress partially applied depreciation recapture to real property with the enactment of section 1250 in 1964. In so doing, however, Congress recognized that different recapture rules were necessary and appropriate for real property. The new recapture rules for real property were limited to depreciation deductions in excess of straight-line depreciation. In addition, the depreciation recapture requirement tapered off if the property was held longer than 20 months, such that it did not apply at all to property held for 10 years or more. Congress concluded that any gain that is not in excess of straight-line depreciation "is attributable to a rise in price levels generally rather than to an absence of a decline in the value of the property."[37]

Unlike prior reforms, the proposal would apply retroactively by imposing the ordinary income tax rate to past depreciation deductions. In enacting section 1250, Congress applied the

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[35] *See* Revenue Act of 1962, Sen. Rept. No. 87-1881, 87th Cong., 2nd Sess. (1962) ("Wherever the depreciation deductions reduce the basis of the property faster than the actual decline in its value, then when it is sold there will be a gain. Under present law this gain is taxed as a capital gain, even though the depreciation deductions reduced ordinary income. The taxpayer who has taken excessive depreciation deductions and then sells an asset, therefore, has in effect converted ordinary income into a capital gain.").

[36] See Douglas A. Kahn, Accelerated Depreciation—Tax Expenditure or Proper Allowance for Measuring Net Income? 78 MICH. L. REV. 1, 4 (1979):

> [T]he depreciation provisions before 1962 had been the source of many heated disputes between taxpayers and the Service. To minimize such disputes and the bad will they generate, Congress adopted a number of liberalizing provisions . . . . Congress felt more comfortable liberalizing the depreciation allowance in that manner when it knew it could recapture 'excessive' depreciation with section 1245.

[37] H.R. Rept. No. 749, 88th Cong., 1st Sess. 102-03 (1963). *See also* Sen. Rept. No. 830, 88th Cong., 2nd Sess. (1964):

> In 1962, Congress did not include real property in the recapture provision applicable to depreciable personal property because it recognized the problem in doing so where there is an appreciable rise in the value of real property attributable to a rise in the general price level over a long period of time. The bill this year . . . makes sure that the ordinary income treatment is applied upon the sale of the asset only to what may truly be called excess depreciation deductions. It does this first by providing that in no event is there to be a recapture of depreciation as ordinary income where the property is sold at a gain except to the extent the depreciation deductions taken exceed . . . the straight-line method of depreciation. Secondly, a provision has been added which in any event tapers off the proportion of any gain which will be treated as ordinary income so that it disappears gradually over a 10-year holding period for the real estate.

new rules to depreciation deductions claimed in tax years after the date of enactment. In contrast, the discussion draft would cover all prior depreciation deductions, provided the sale of the property occurs after 2014. This aggressive clawback of prior depreciation deductions would penalize taxpayers who relied on the existing and well-grounded statutory cost recovery rules.

The case for imposing a new tax liability on recaptured depreciation deductions is particularly weak when it is coupled with reforms that tighten depreciation lives and methods. As demonstrated above, current law cost recovery rules already understate the economic rate of depreciation for real estate. Much of the gain from the sale of real property reflects appreciation of the underlying land, which is non-depreciable, and the compounding effect of inflation. The 25 percent tax rate that applies to the amount of gain attributable to straight-line depreciation takes into account these other elements that are present with every real property sale.

V. Commercial Real Estate and Energy Efficiency

While the tax code should strive to remove tax considerations from business decisions as much as possible, in certain limited instances, externalities result in prices and market behavior that fail to fully reflect the social costs of economic activity. One area where this problem arises is energy usage and commercial real estate. Tax incentives for energy efficiency can help correct these imbalances.

A. The Finance Discussion Draft would discourage energy-efficiency investments in our nation's buildings.

Residential and commercial buildings, and the homeowners, tenants, and other occupants who live, work and play in them, account for approximately 40 percent of the nation's energy consumption (relative to the industrial and transportation sectors).[38] Improving the energy efficiency of buildings is the most cost-effective means available for moving the nation toward energy independence and energy security. An "all of the above" national energy policy must include measures that help make our built environment more efficient. Unfortunately, the discussion draft goes against the grain of progress insofar as efficiency is concerned, and would turn the tax code into a tool to encourage energy use and waste as opposed to energy savings in buildings.

1. The Finance Discussion Draft would repeal the only tax provision that promotes energy-efficient improvements to commercial buildings.

The discussion draft would repeal section 179D, the tax deduction to incentivize high levels of energy efficiency in the nation's commercial and larger multifamily buildings. Section 179D encourages owners to install high performance heating, lighting, windows, roofs, and other systems that exceed baseline requirements imposed by building energy codes. The upfront expenses of such systems impose significant costs on real estate owners. While any amounts available under section 179D do not cover the entire cost of state-of-the-art systems,[39] the deduction allows

[38] U.S. Energy Information Administration, *Monthly Energy Review* (Nov. 2013), Table 2.1a: "Energy Consumption by Sector," *available at* http://www.eia.gov/totalenergy/data/monthly/pdf/sec2_3.pdf.

[39] Section 179D provides a maximum deduction of $1.80 per square foot, where "energy efficient building property" is installed and certified as part of a plan so that an entire building is expected to exceed minimum energy code requirements by 50 percent. 26 U.S.C. §§ 179D(b)(1), (c)(1)(D). A "partial allowance" of

building owners to more quickly recoup returns on their investments—an incentive to go "deeper" with upgrade projects that achieve higher levels of energy savings. A report by the American Council for an Energy-Efficient Economy explains that section 179D ranks at the top of a list of incentives that provide taxpayers with the most "bang for the buck" to achieve important energy policy goals with a modest absolute impact on the federal budget.[40]

2. Congress should make section 179D permanent with meaningful improvements to spur building retrofit projects.

Rather than repealing section 179D, the Committee should move in the direction of a legislative proposal from the 112th Congress, the Commercial Building Modernization Act (CBMA) (S. 3591) sponsored by Senators Cardin and Feinstein and former Senators Bingaman and Snowe. The CBMA will unleash section 179D's potential to spur existing building retrofit projects, create jobs, improve the environment, and move our nation closer toward energy independence.

B. Section 179D and rational depreciation rules are needed to align the tax code so it properly incentivizes energy savings in buildings—not energy use or waste.

The tax code allows businesses to immediately deduct "ordinary and necessary" operating expenses.[41] Electric, gas, water, and other utility bills are deducted for tax purposes as they are incurred. In contrast, the costs to purchase and install highly efficient building equipment and components are capitalized and recovered over an extended period, which would be even longer if the depreciation proposals in the discussion draft are enacted. Thus, tax incentives such as section 179D and tax recovery periods that accurately account for the economic life of real property, are critical in aligning the tax code so that it properly distributes the tax burden between capital investments that save energy and operating expenses for consuming energy.

* * *

In light of the impact of real estate on the national economy, the Finance Discussion Draft's proposed changes in commercial real estate taxation would dramatically affect not only real estate investment activities, but also the health of the U.S. economy, job creation, retirement savings, lending institutions, pension funds, and, of course, local communities. The proposals would discourage capital formation and distort the flow of capital investment, reduce taxpayers' confidence that current rules will apply throughout the life of an investment, and unjustly put commercial real estate at a competitive disadvantage relative to other industries.

Taxation of real estate assets and entities that instead recognizes the true economic life of buildings and structures would promote employment and facilitate sound, environmentally-responsible real estate investment and development. Such reform would contribute to strong

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$.60 per square foot is allowed where individual systems meet energy savings performance targets established by the IRS. *Id.* § 179D(d).

[40] American Council for an Energy-Efficient Economy, *Tax Reforms to Advance Energy Efficiency*, Report No. E132, at 7-8 (Feb. 2013), *available at*: http://aceee.org/research-report/e132.

[41] 26 U.S.C. § 162(a).

property values and well-served, livable communities.

We recognize that the discussion draft is a first effort at creating a simpler, fairer, and more modern tax system for the future. We understand that the issues are complex and the tradeoffs are significant. And we appreciate the transparent approach to tax reform that you and your staff have embraced. We look forward to working with the Committee in the weeks and months ahead to ensure that tax reform helps strengthen the economic recovery.

Sincerely,

The Real Estate Roundtable
American Institute of Architects
American Land Title Association
American Resort Development Association
Appraisal Institute
Associated General Contractors of America
Building Owners and Managers Association International
CCIM Institute
Institute of Real Estate Management
International Council of Shopping Centers
NAIOP, the Commercial Real Estate Development Association
National Apartment Association
National Association of Home Builders
National Association of Real Estate Investment Trusts
National Association of REALTORS®
National Multi Housing Council
Real Estate Board of New York
REALTORS® Land Institute
Society of Industrial and Office REALTORS®