NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

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REITS: BUILDING DIVIDENDS AND DIVERSIFICATION®

January 17, 2014

VIA E-MAIL: Tax_Reform@Finance.Senate.gov

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

Re: Comments on Cost Recovery and Accounting Staff Discussion Draft

Dear Chairman Baucus:

The National Association of Real Estate Investment Trusts[1] (NAREIT) welcomes the opportunity to provide comments on the cost recovery and tax accounting rules included in the Senate Finance Committee Staff Discussion Draft released on November 21, 2013 (the Discussion Draft). [2] NAREIT looks forward to working with the Finance Committee (the Committee) with respect to the proposals contained in the Discussion Draft.

EXECUTIVE SUMMARY

As relevant to our comments, the Discussion Draft proposes to: 1) repeal the long-standing rules that permit real estate owners to defer tax on the exchange of "like kind" property when there has been no "cashing out" of the investment while retaining a variation of deferral for owners of properties in non-real estate industries; 2) increase the tax rate on recaptured depreciation from 25% to 39.6% (ignoring any applicable 3.8% surcharge) retroactively, thereby increasing the cost of investing in real estate; 3) extend the cost recovery period for all real estate (including second-generation tenant improvements and certain energy efficiency expenditures) to 43 years based on outdated studies of economic life; and, 4) eliminate the section 194 deduction for reforestation expenses.

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[1] NAREIT® is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate, and finance income-producing real estate, as well as those firms and individuals who advise, study, and service those businesses.

[2] Available at http://www.finance.senate.gov/newsroom/chairman/release/?id=536eefeb-2ae2-453f-af9b-946c305d5c93. References to "section" or "§" in this letter refer to sections of the Internal Revenue Code of 1986, as amended (the Code or I.R.C.). References to "Proposed section" refer to the Code as it would be amended by the Discussion Draft.

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We support the relevant comments in the letter to you from the national real estate organizations dated January 16, 2014. We also believe it is important and useful for us to expand upon and emphasize certain of those comments especially relevant to REITs.

Although the Discussion Draft would retain some form of gain deferral rules in the pooling proposed for non-real estate assets, the Discussion Draft also would repeal the like kind exchange rules for real estate assets, unfairly singling out the real estate industry for unfavorable treatment with respect to deferral on the exchange of assets. In general, we strongly believe that repeal of the like kind exchange rules with respect to real estate assets would generally result in fewer real estate transactions, inefficient use of capital and reduced property improvements. As described below, REITs have limited ability to retain capital and expand their portfolios. Repeal of the like kind exchange rules would significantly limit REITs in their ability to recycle and reposition capital, which could lead to inefficient allocation of capital and stagnation or decline in real estate values and share prices.

Furthermore, the extension of the cost recovery period for all real property - far in excess of economic life - to 43 years based on outdated studies and retroactive application of such extension would be fundamentally unfair, could curb needed investments in real estate and would negatively affect future job growth. Because REITs are legally unable to retain significant amounts of cash by virtue of their distribution requirement, insufficient recognition of depreciation expense would result in a greater required distribution amount and less capital available for property reinvestment and improvement.

DISCUSSION

A. Background

Congress enacted REIT legislation more than 50 years ago to ensure that Americans from all walks of life could access the real estate asset class on a collective basis to secure greater investment diversification with the benefit of professional management.

REITs are entities that are taxed as corporations that operate under strict rules, including gross income and asset tests, designed to ensure that they are focused on long-term ownership and financing of real estate. These rules are based upon and are similar to the rules under which mutual funds are required to operate. Modern-day REITs themselves are a product of tax reform, as the Tax Reform Act of 1986 specifically allowed REITs for the first time to be internally managed. This constructive change set the stage for the REIT industry of today, which benefits the economy and their investors.

The equity securities of stock exchange-listed REITs trade on established securities exchanges, mostly on the NYSE. About 200 stock exchange-listed REITs own nearly $1 trillion of real estate, represent an equity market capitalization of over $700 billion, and help support over 1 million jobs. Additionally, the securities of many public non-listed REITs are also registered with the Securities and Exchange Commission (SEC), thus subjecting them to the annual and periodic reporting requirements of the Securities and Exchange Act of 1934.

Similar to mutual funds, REITs are required to distribute at least 90% of their taxable income each year to their shareholders as dividends, thus limiting the amount of cash they have on hand for new investments and property improvements. The shareholders pay tax on the dividends, primarily at the ordinary income rate, not the lower qualified dividend rate. Since REITs would pay corporate tax on the up to 10% of taxable income retained, market forces generally compel REITs to distribute at least 100% of their taxable income. SEC-registered REITs distributed $29 billion to shareholders in 2012. Due to shareholder expectations, most SEC-registered REITs maintain relatively low leverage. For example, as of September 30, 2013, the debt ratio (total debt divided by total market capitalization) for all stock exchange-listed equity (or property-owning) REITs was 35.5% (and for all stock exchange-listed REITs, including mortgage REITs, was 49.6%).

REITs' required dividends have made them a key part of the investment landscape. Increasingly, REITs are used as a tool to help diversify investment portfolios. Since 1960, REITs have helped provide Americans with significant income through their mandatory dividends, investment diversification through the requirement to focus on the real estate asset class and competitive investment performance which for many periods has outpaced other stocks and bonds. Due to the success of the U.S. REIT industry, a number of other countries around the world have adopted their own REIT laws modeled after the U.S. approach. Today, about 30 countries have such laws, including all the G-8 nations (other than Russia).[3]

The existence of REITs has proven beneficial to the economy and to investors. Yet, these positive results, in large part attributable to the REIT distribution requirement, do come at a cost. Given their inability to retain significant earnings, to grow REITs must regularly access the capital markets and utilize techniques to retain capital, such as use of the like kind exchange rules.

As Fitch Ratings noted in a February 5, 2013 report:

> "The REIT structure also implicitly enhances management discipline with respect to capital allocation. Since REITs are unable to retain sizable amounts of cash flow, they are much more dependent on accessing the capital markets than standard corporate borrowers. As such, REITs essentially require tacit approval from investors to invest new capital in acquisitions and other growth opportunities, whereas standard corporate entities lack this implied market check."[4]

[3] For further detail regarding the positive effects of REITs on the economy and investors, please see NAREIT's submission to the House of Representatives' Ways and Means Committee's Real Estate, Energy, International, Pensions/Retirement, Debt, Equity and Capital, Education and Family Benefits, Charitable/Exempt Organizations, Financial Services and Small Business Tax Reform Working Groups dated April 15, 2013, available at http://waysandmeans.house.gov/uploadedfiles/nareit_wg_comments.pdf.

[4] https://www.fitchratings.com/gws/en/fitchwire/fitchwirearticle/REIT-Structure-Reinforces?pr_id=782044.

Of course, external forces, such as the most recent financial crisis and recession may significantly limit REITs' ability to raise additional capital. In such a situation, the ability to retain capital and reposition assets becomes even more important.

B. Discussion Draft Proposals

1. Would Reduce Liquidity of Real Estate Investment by Eliminating Deferral for Like Kind Exchange and Narrowing Involuntary Conversion Rules

For non-real estate assets, as described below, the Discussion Draft would implement a pooling system for cost recovery purposes. However, the Discussion Draft would not apply a pooling system for most real estate assets, but instead would require depreciation of these assets separately over a 43 year recovery period. The Discussion Draft also would repeal section 1031 (a part of the Code since 1921), which provides that no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a "like-kind" that is to be held for productive use in a trade or business or for investment.

The Discussion Draft would also modify section 1033, which applies to sales or exchanges of property due to involuntary conversion. Under current law, if property is involuntarily converted into property that is similar or related in service or use to the property so converted,[5] no gain is recognized, and the treatment is not elective. On the other hand, the taxpayer can elect nonrecognition if the taxpayer receives cash (*e.g.,* insurance payments or condemnation awards), or other dissimilar property for the involuntarily converted property, and acquires qualified replacement property within the prescribed time period. The Discussion Draft would repeal the "like kind property" standard of section 1033(g) for involuntary exchanges involving real property.

The end result of these proposals would be to treat exchanges of non-real estate assets differently than exchanges of real estate assets; the former would be entitled to tax deferral (so long as the value of the relevant asset pool were not negative), while the latter would not.

2. Would Increase Cost of Capital and Create Burdensome Complexity by Taxing Depreciation Recapture at Ordinary Income Rates

The Discussion Draft would increase the tax rate applicable to gains from the disposition of real estate assets by increasing the tax rate applicable to "depreciation recapture" (prior year depreciation deductions) from 25% to the applicable ordinary income tax rate, currently 39.6%, effective for taxable years after December 31, 2012.

[5] Section 1033(g) provides that "[f]or purposes of subsection [1033](a), if real property (not including stock in trade or other property held primarily for sale) held for productive use in trade or business or for investment is (as the result of its seizure, requisition, or condemnation, or threat or imminence thereof) compulsorily or involuntarily converted, property of a like kind to be held either for productive use in trade or business or for investment shall be treated as property similar or related in service or use to the property so converted." Thus, section 1033(g) essentially imports a "like kind" standard into section 1033 for certain involuntary conversions of real property.

3. Would Increase Cost of Capital and Raise Cost of Incurring Energy Efficiency Expenditures through Retroactive/Prospective Extension of Cost Recovery Periods to All Real Estate Assets and Repeal of Section 179D

The associated Summary of the Discussion Draft (Summary) describes the cost recovery changes as follows:

> The [Discussion Draft] repeals the current MACRS and ADS rules and replaces them with the following simplified cost recovery system that better approximates economic depreciation. The new system results in a single set of depreciation rules that apply to all business taxpayers. … The new depreciation system for tangible personal property (other than personal use automobiles) and computer software is comprised of 4 pools, with 3 designated for short to mid-term property and 1 designated for mixed-use structures and other longer-term personal property. .. . . Real property is depreciated, as under current law, on a straight-line basis, but over 43 years.

Thus, a 43 year recovery period would apply to all real property (other than certain land improvements), including tenant improvements (currently depreciated over 15 years if a taxpayer so elects) and energy efficiency expenditures under section 179D (which, prior to expiration at the end of 2013, allowed a deduction for such expenses in year incurred, but over 5 years for earnings and profits purposes; repealed under the Discussion Draft). Furthermore, land improvements including parking lots, lighting, and fences that are currently depreciated over 15 years, would be depreciated over 20 years under the pooled cost recovery system proposed for most non-real estate assets.

For real estate, the Discussion Draft proposes what is called a "transition rule," which would apply to property placed in service prior to January 1, 2015. The rule would mandate that the adjusted basis of such property would be depreciated over 43 years, reduced by the number of taxable years for which the property has already been depreciated. In fact, this effective date would retroactively impose a longer cost recovery system on investments made under previous law.

4. Repeal of Section 194 Deduction for Certain Reforestation Expenses

The Discussion Draft proposes to repeal section 194. Section 194 provides an immediate deduction of up to $10,000 for reforestation costs (*e.g.*, replanting costs) per stand, with the remaining costs amortizable over seven years. If repealed, forest owners would need to capitalize and recover costs when the timber is harvested, which could take 25-80 years on a per stand basis.

C. Comments

1. Repealing Like Kind Exchange Deferral and Modifying Section 1033 Would Inhibit Real Estate Investment

a. Deferring Recognition for Like Kind Exchanges is Appropriate When There Has Been No "Cashing Out" of an Investment

NAREIT appreciates the Finance Committee's request for comments regarding whether to retain the like kind exchange rules of sections 1031 and 1033 with respect to exchanges of real estate assets. NAREIT believes that the Discussion Draft's proposed repeal of like kind exchange rules with respect to real estate, while proposing to retain some form of tax deferral with respect to exchanges of non-real estate assets, discriminates against the real estate industry for unfavorable treatment with respect to exchanges of assets that involve no real "cashing out" of an investment. Much like the reorganization rules in section 368 generally provide for deferral of gain or loss in connection with transactions in which taxpayers do not cash out of their investments but merely adjust its form, [6] tax policy has recognized since 1921 that the exchange of property for property of a like kind results in no economic change to the taxpayer. The repeal of section 1031 and the modification of the "like kind property" standard of section 1033 would quite substantially reduce the liquidity of the real estate market and constrain capital available for reinvestment.

b. Repealing Deferral for Like Kind Exchanges Would Prevent Efficient Allocation of Capital

Furthermore, repealing section 1031 would prevent real estate owners from efficiently allocating capital to its most productive use. Specifically, the use of like kind exchanges allows taxpayers to reposition portfolios, exchange non-core assets for core assets, concentrate and/or diversify geographic holdings while, at the same time, providing economic stimulus by increasing the frequency of transactions. Under the long-standing section 1031 rules, for example, taxpayers now regularly exchange a stabilized income-producing asset for land on which they can construct new buildings.

Repealing section 1031 additionally would restrict the ability of a taxpayer to engage in conservation transactions involving undeveloped or environmentally sensitive properties because the taxpayer would not be able to defer gain by reinvesting in other like-kind property. Under existing section 1031 authority, a perpetual conservation easement is like-kind to a fee interest in improved or unimproved real property. *See, e.g.*, PLR 9215049, PLR 9851039 and PLR

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[6] *See* Bazley v. Commissioner, 331 U.S. 737 (1947) (in addressing Section 112 (g), the predecessor to section 368, "[b]ut there are circumstances where a formal distribution, directly or through exchange of securities, represents merely a new form of the previous participation in an enterprise, involving no change of substance in the rights and relations of the interested parties one to another or to the corporate assets. As to these, Congress has said that they are not to be deemed significant occasions for determining taxable gain"). *See also* Treas. Reg. § 1.368-1(b) ("The purpose of the reorganization provisions of the Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures made in one of the particular ways specified in the Code, as are required by business exigencies and which effect only a readjustment of continuing interest in property under modified corporate forms.")

9621012. *See also* PLRs 9215049 (April 10, 1992); 9621012 (May 14, 1996); and 9851039 (December 18, 1998). As discussed below, adopting a "similar use" test for replacement property is in most cases more restrictive and would likewise hinder the ability of a taxpayer to promote conservation.

These examples are the very essence of how the commercial real estate industry creates jobs, supplies needed investment in communities, meets consumer demands and increases property values. Adding layers of taxes to a like kind exchange when the taxpayer receives no cash from the exchange would curtail these needed investments, limit promotion of conservation and could lead many investors to instead retain their current investments, leading to a "lock-up" effect that is detrimental to economic growth.

c. Because of the REIT Distribution Requirement, Eliminating Tax Deferral from Like Kind Exchanges Would Limit REITs' Ability to Create Value

In addition to generally deleterious effects to the overall real estate industry by the proposed repeal of section 1031, the repeal of the like exchange rules could have particularly adverse effects on REITs. First, as noted above, REITs are required to distribute at least 90% of their taxable income, and face entity-level tax on whatever income they retain. Requiring distribution of a large portion of cash from sales proceeds thereby reduces the amount of cash available for future developments, repairs, property improvements and the like. It also limits the ability of REITs to exit non-core markets in favor of core markets. To compensate, REITs can avail themselves of the deferral effects of the like kind exchange provisions in order to reallocate the capital from one investment asset to a different, more appropriate asset. Repealing section 1031 would prevent REITs from doing so.

Second, the existing like kind exchange rules allow REITs the ability to reposition their portfolios by exchanging properties without having to risk a 100% "dealer sales" tax on the gains from any sold or exchanged properties. Specifically, because REITs were created to be long-term owners of income-producing real estate, Congress imposed a 100% tax on net income from sales of property held "primarily for sale to customers in the ordinary course" of a REIT's trade or business (so-called prohibited transactions or dealer sales). Since the determination of whether property is held in the ordinary course of business requires a highly fact-specific analysis, it cannot be made with complete certainty. Because the 100% dealer sales tax is so draconian, Congress has also recognized the need for a REIT to sell assets to prudently manage property portfolios to maximize shareholder returns. For example, a REIT may decide to sell properties in one area of the country it has owned for many years and deploy the funds received for that sale to acquire properties in another geographical area it considers will provide a better return on investment. Consequently, Congress also established a bright line safe harbor for determining whether a REIT's property sale constitutes a prohibited transaction.

Among other requirements, this safe harbor requires that: a) the REIT did not make more than seven sales of "property" during the year (Seven Sales Rule) or b) either i) the aggregate adjusted bases of all "properties" sold during the year do not exceed 10% of the aggregate bases

of all of the REIT's assets as of the beginning of the year, or ii) the fair market value of all "properties" sold during the year does not exceed 10% of the fair market value of all of the REIT's assets as of the beginning of the year (10% Rule).

The legislative history behind this dealer sales safe harbor indicates that Congress believed that "REITs should have a safe harbor within which they can modify the portfolio of their assets without the possibility that a tax would be imposed equal to the entire amount of the appreciation in those assets" and that the restrictions on the availability of the safe harbor would "prevent REITs from using the safe harbor to permit them to engage in an active trade or business such as the development and subdivision of land." S. Rep. No. 95-1263, 95th Cong., 2d Sess. 178-179 (1978).

The IRS has issued a number of private rulings to REITs holding that the use of like kind exchanges would be "consistent with the Congressional intent of allowing REITs to modify their portfolios without incurring a prohibitive tax." *See, e.g*., PLR 200701008 (January 5, 2007); PLR 200702001 (January 12, 2007) (similar, but that, to the extent that there is boot received in a deferred like-kind exchange, only the same proportion of the adjusted basis of the relinquished property as the boot bears to the total consideration received will be used for calculating the 10% Rule), and PLR 200728037 (July 13, 2007) (similar holding with respect to timberlands). Absent the ability to avail themselves of the rules of section 1031, the REITs in these rulings would not have been able to reposition portfolios and more effectively deploy capital with certainty that the gains from such actions would be exempt from the 100% dealer sales tax.

Third, like most other real estate owners, REITs conduct a substantial part of their business through partnerships. Many of the approximately 200 publicly traded REITs hold all of their assets through an operating partnership (OP), the majority of the interests of which are held by the REIT. This structure is known as the umbrella partnership or "UPREIT" structure. The UPREIT structure was developed to facilitate the desire of real estate owners to be able to access the public capital markets through the flow-through structure commonly used in the real estate industry while deferring the immediate recognition of taxable gain that would result if they were to transfer their properties or property-owning partnership interests directly to the REIT in exchange for REIT shares, rather than to the OP in exchange for units.

In general, while the transfer of property to a REIT in exchange for REIT shares in connection with the formation of the REIT often will result in the recognition of gain for tax purposes, this tax gain can be deferred if the property owner instead receives OP units, rather than REIT shares. The IRS has indicated that it does not consider the UPREIT structure negatively.[7]

Since much of the real estate industry holds real estate in partnership form, the use of an UPREIT structure is consistent with the structures used by non-REIT real estate investors, and the existence of these rules encourage real estate transactions by joining REITs with limited cash available to purchase properties with investors who may have limited cash available to pay tax on appreciated investments. However, because many property contributions to OPs may have section 704(c) gain that would be taxable to the contributor upon the OP's taxable disposition of

[7] See, e.g. Example 4 of Treas. Reg. § 1.701-2 (the partnership anti-abuse regulations).

the property, OP agreements typically contain "lock-out" provisions that prohibit taxable dispositions of such property within a certain period absent the REIT's indemnity of such contributor. These "lock out" provisions typically permit dispositions through like kind exchanges and/or certain partnership contributions. Repealing the like kind exchange rule of section 1031 not only would limit dispositions of OP property as a result of the increased tax cost and the REIT distribution requirement, it also would implicate the lock out provisions of these partnership agreements, further reducing liquidity in the real estate market.

d. Replacement of Like Kind Exchange Provisions with "Similar Use" Standard for Real Estate Only Would Violate Tax Neutrality Principles and Would Be Inadequate both For Like Kind Exchanges and Involuntary Conversions

As noted above, section 1033(a) generally provides for nonrecognition of gain in connection with involuntary conversions when the involuntarily converted property is exchanged for property "similar or related in service or use". Section 1033(g) provides, among other things, that "similar or related in service or use" in the context of real property conversions basically includes "like kind" property under section 1031 when the converted and the replacement property are both held for productive use in a trade or business or for investment. The Discussion Draft would repeal section 1033(g), thereby limiting replacement property in involuntary conversions to property that satisfies the "similar use" standard of section 1033.

Although the Discussion Draft would repeal the like kind exchange rules of section 1031 entirely, the Senate Finance Committee has requested comments as to whether the "similar use" standard applicable to involuntary conversions under section 1033(a) should be retained with respect to exchanges of real estate. NAREIT appreciates the Finance Committee's request but believes that the similar use standard, while an improvement over complete elimination of the like kind exchange rules for real estate, would be insufficient and would unfairly favor exchanges of personal property.

First, the Discussion Draft essentially would apply a much broader standard to exchanges of personal property than the "similar use" standard that might be considered for exchanges of real property. As we understand the proposal, the exchange of an asset in one of the four pools for another asset in the same pool (*e.g.,* a taxi in pool 1 for a computer in pool 1) would only give rise to gain if the end-of-year adjusted basis in that particular pool is below zero. The pool balance's adjusted basis would be calculated by adding the cost of additions, subtracting proceeds received for dispositions, and also subtracting depreciation allowances. Thus, while selling a taxi would reduce the pool balance in pool 1 by the amount of the proceeds, acquiring another asset belonging to that pool, such as one or more computers for the same amount of proceeds, would increase the pool balance by the cost of that asset, and no gain would be recognized.

On the other hand, in Rev. Rul. 64-237, 1964-2 C.B. 319, the IRS explained its position with respect to the phrase "similar or related in service or use" when applied for a taxpayer-investor (such as a taxpayer that may rent properties and hold them for investment as opposed to a

taxpayer that owns and operates its properties).[8] In such cases, the focus would be on the similarity in the relationship of the services or uses that the original and replacement properties had to the taxpayer-investor. In applying this test, the IRS considers whether business risks associated with the properties and the demands on the taxpayer, in terms of providing management services, were sufficiently similar. If so, the replacement property would be considered similar or related in service or use. In PLR 201015015 (January 5, 2010), the IRS cited Rev. Rul. 64-237 and noted that the "like kind" standard of section 1033(g) is a "separate and distinct" standard from the "service or related in service or use" standard under section 1033(a). Clearly, the "similar use" test is, in most cases, a narrower test for replacement property than that proposed for personal property by the Discussion Draft.

However, PLR 201015015 also notes that in some cases the "like kind" standard can be narrower than the "similar use" test. For example, under the like kind standard of section 1033(g), a leasehold interest qualifies as being of like kind to a fee interest only if the lease will continue at least 30 additional years. On the other hand, the requirement that a lease have a remaining term of at least 30 years is inapplicable to the determination of whether a fee interest is "similar or related in service or use" to a leasehold interest. *See also* Rev. Rul. 83-70, 1983-1 C.B. 189 (citing Treas. Reg. § 1.1031-1(c) to hold that a fee interest in property is not like kind to a leasehold interest with a remaining term of 15 years but is "similar or related in service or use" because it will be used by the taxpayer in the same business and for the identical purposes as the condemned leasehold). The ability of a taxpayer to replace rental real property with property that qualifies under either standard is particularly important in the context of involuntary conversions, and NAREIT recommends the Finance Committee to retain both standards for purposes of section 1033.

In the context of voluntary conversions, NAREIT urges the Finance Committee to retain the long-standing "like kind" exchange as the appropriate standard. Applying a similar use standard for real estate exchanges while using a different standard for exchanges of non-real estate would violate tax neutrality. Given that one of the Discussion Draft's goals is to create a fairer tax system, it seems inappropriate to propose a broader deferral rule for personal property exchanges than for real property exchanges.

Additionally, limiting deferral only to exchanges of real property for property similar in service or use would reduce liquidity in the real estate market by limiting the pool of assets available for an exchange and would curb the economic development opportunities afforded by the exchange of a developed building for land. In the case of the Discussion Draft's repeal of the "like kind" standard of section 1033(g) for involuntary conversions, it seems particularly unfair to require taxpayers whose properties are converted involuntarily to face gain recognition if they are unable

[8] Typically, most REITs would be taxpayer-investors because they hold property for investment or the production of rental income. In the context of the "owner-user" of real property, the IRS in Rev. Rul. 64-237 stated that a "functional use" test is the appropriate test for determining "similar use." The "functional use" test is narrower than the test applied to owner-investors. It requires that replacement property in involuntary conversions have a "close 'function' similarity to the property converted." Specifically, "property was not considered similar or related in service or use to the converted property unless the physical characteristics and end uses of the converted and replacement properties were closely similar."

to locate and acquire "similar use" property in exchange. These concerns are magnified for REITs for the reasons discussed above.

For these reasons, NAREIT recommends retaining section 1031 with respect to voluntary real property exchanges and the like kind standard of section 1033(g) for involuntary conversions.

2. Taxing Depreciation Recapture at Ordinary Income Rates Would Increase Taxes on Real Estate Investment and Create Burdensome Complexity for REITs

The Discussion Draft's proposal to increase the tax rate on the portion of real estate gains attributable to depreciation to the ordinary gain rate (currently 39.6% for individuals) would discourage real estate investment, is inconsistent with Congress's intent regarding taxation of real estate ownership and would retroactively change the rule with respect to prior depreciation deductions taken. These concerns are discussed in detail in the letter submitted by the national real estate organizations referred to above.

NAREIT would also like to highlight that the change to the general rule in section 1250(a) to include all depreciation on section 1250 property would add substantial complexity to many real estate partnership distributions, redemptions and transfers of partnership interests since all potential depreciation recapture with respect to the partnership's real property would be considered an "unrealized receivable" under section 751(c)(2). For REITs in particular, as described above, the UPREIT structure is commonly used and redemptions of OP unitholders are not uncommon. The construct under section 751(b) for a deemed sale or exchange of property between distributee partner and the partnership can result in unintended consequences for both the REIT and the OP unitholders. Further, real estate joint ventures and funds often attempt to unwind in a tax-deferred manner by distributing assets in liquidation. Under the Discussion Draft proposal, the ability to unwind a real estate partnership without any gain recognition would be severely if not completely hampered by the application of section 751(b).

For these reasons, NAREIT recommends retaining the current rules regarding unrecaptured section 1250 gain.

3. Extension of Cost Recovery Period to 43 Years for All Real Property is Based on Outdated Studies and Would Be Inconsistent with Actual Economic Depreciation and Would Raise Costs of Incurring Energy Efficiency Expenditures

The Discussion Draft's proposed 43 year cost recovery period raises a host of potential issues that were also discussed in detail in the letter submitted by the national real estate organizations referred to above. In particular, NAREIT would like to highlight the following issues.

First, NAREIT appreciates the Finance Committee's goal of conforming the actual cost recovery schedule for all assets to true economic depreciation as supported by current data. However, NAREIT recommends that Congress first commission new studies that would provide more current data, just as it did in 1998, when it requested the Treasury Department to evaluate

whether the MACRS cost recovery periods were appropriate. It should come as no surprise that real estate assets depreciate faster than in the 1960s since the real estate markets must continually meet updated tenant demands. For example, the configuration of offices for financial service firms' trading desks and law firms' decreased use of libraries and legal secretaries create demand for new floor plans, and the increasing tenant preference for energy-efficient real estate has made older buildings less valuable in the same way that buildings without air conditioning in the 1950s became obsolete.

In particular, the data relied upon by the Finance Committee's Discussion Draft in order to propose a 43 year cost recovery period for all real estate assets is many decades out of date.[9] Even studies based on 15-year old data conclude that the existing cost recovery period for real estate is too long. For example, in a study published in 2000 and 2001,[10] Hy Sanders and Randall Weiss of Deloitte & Touche LLP undertook to update 30 year old data (specifically noting that such data "continues to be relied upon by economists in their studies of economic depreciation of real estate").[11] Its conclusion was that "in order for tax depreciation to correspond to economic depreciation, it will be necessary for the tax rules to apply a recovery period of between 18 and 23 years, depending upon the type of structure (*e.g.*, retail versus residential)."[12] Economist Jane Gravelle of the Congressional Research Service similarly has noted that the "[depreciation] system should be monitored and attempts made to update economic depreciation estimates."[13]

Further, the proposed 43 year life for commercial real estate structures would contravene one of the stated reasons underlying tax reform, namely designing a tax system that is competitive with other tax regimes around the world. As documented by the Joint Committee on Taxation, the cost recovery periods for commercial real estate under current law are **longer** than under most

[9] Specifically, the Discussion Draft apparently relies on Congressional Budget Office (CBO) data, which itself is based on Bureau of Economic Analysis's reliance on studies from the 1960s and 70s. *See* notes to CBO Director Douglas W. Elmendorf's letter to Chairman Max Baucus (November 21, 2013) (*available at* http://www.cbo.gov/publication/44911, stating: "[t]he 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. The BEA notes its reliance on studies from as long ago as 1963.

[10] Hy Sanders and Randall Weiss, *Analysis of the Economic and Tax Depreciation of Structures*, [Vol. 16] TAX MGMT. REAL EST. J. (BNA) 343 (December 6, 2000) (Study Part One) and Hy Sanders and Randall Weiss, *Analysis of the Economic and Tax Depreciation of Structures (Part Two)*, [Vol. 17] TAX MGMT. REAL EST. J. (BNA) 3 (December 6, 2000) (Study Part Two).

[11] Study Part One at 343.

[12] *Id.* In fact, Study Part One concluded that because component parts of structures tend to depreciate faster than the structures themselves, the findings "support the proposition that, for tax purposes, the appropriate depreciation period for structures is no greater than 20 years." Study Part Two at 15.

[13] Jane G. Gravelle, *Whither Tax Depreciation?* Vol. LIV NATIONAL TAX JOURNAL (Sept. 2001) 523, at 525. Dr. Gravelle also noted that "[t]here 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." *Id.*

competing nations' tax laws.[14] Lengthening these periods beyond the current cost recovery periods would be a step precisely in the wrong direction.

Second, NAREIT recommends that the Discussion Draft be amended to allow for a shorter recovery period at least for certain component parts of real estate structures, which we are confident updated studies will confirm is appropriate. As an example, currently second generation leasehold improvements should be depreciable over 15 years (both for taxable income and earnings and profits purposes). In fact, commercial practice dictates that these improvements do not generally last longer than the life of their associated leases, which are typically no longer than 5 to 10 years. The Discussion Draft would repeal the 15 year cost recovery period for these leasehold improvements, resulting in a cost recovery period of 43-years, more than four times as long as the typical commercial lease.

In addition, the Discussion Draft would repeal section 179D, which, until it expired at the end of 2013, provided an immediate deduction for the cost of high efficiency components and systems (such as windows, roofs, lighting, and HVAC) in commercial and larger multifamily buildings that met certain energy savings performance targets, thereby increasing the costs of incurring these expenditures. A wide and varied group of stakeholders for a number of years has urged section 179D's extension and reform along the lines of the provisions incorporated in S. 3591, the *Commercial Building Modernization Act*, from last Congress. That bill, introduced by Senators Cardin and Feinstein, and former Senators Bingaman and Snowe, would have required that entitlement to the section 179D deduction be "performance based." Further, the deduction is "technology neutral;" it would have been available so long as the requisite efficiency targets were met in accordance with the bill. The Obama Administration's Fiscal Year 2014 Budget Proposal also endorsed an extension and reform of section 179D along these lines.[15]

Current tax law has the perverse effect of discouraging energy efficiency by providing a deduction for utility costs while requiring that expenses to reduce these costs through energy efficiency improvements be written off over the life of the associated building. The Discussion Draft would magnify this discrepancy by extending the relevant cost recovery period for such expenditures to 43 years, further increasing their cost.

The staff summary of the separately issued Senate Finance Committee Staff Discussion Draft on energy tax incentives similarly does not include efficiency incentives like section 179D (and the Staff Summary of such Draft states this omission is due to the Committee's "choice … to target

[14] "Description of the Treatment by Certain Countries of the Cost Recovery for Business Investment in Tangible and Intangible Assets" prepared by the Joint Committee on Taxation (April 2, 2013) (cited in Marie Sapirie, *Cost Recovery Rules Around the World,* TAX NOTES (January 13, 2014), 146, 149 ("The rules for building owners are relatively disadvantageous in the United States compared with other countries.")

[15] *See* Department of the Treasury, "General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals" (April 2013), available at http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf, at 21 ("Enhancing the current deduction for energy efficient commercial building property – which is primarily used by taxpayers constructing new buildings – and allowing a new deduction based on the energy savings performance of commercial building property installed in existing buildings would encourage private sector investments in energy efficiency improvements.")..").

tax incentives on areas that appear to have the largest **bang-for-the-buck** in reducing air pollution and enhancing energy security ….") (Emphasis added). Along those lines, we note that studies have shown that "[s]aving a kilowatt-hour through energy efficiency improvements is easily one-third or less the cost of any new source of electricity supply, whether conventional fossil fuel or renewable energy source."[16] With that in mind, we recommend that, when Congress considers the allocation of scarce resources, Congress enact a modified version of section 179D similar to that described in S. 3591.

Among other things, the reforms to section 179D included in S. 3591 would have: a) encouraged retrofitting of existing buildings by targeting energy savings compared to the existing building energy cost baseline; b) linked the amount of the incentive to energy savings achieved; c) tied a portion of the tax incentive to implementation of efficiency measures and a portion to demonstrated energy savings; and d) allowed owners or tenants to claim some incentive for improving a substantial space within a building.

In addition, S. 3591 would have modified section 179D to make the tax incentive useable for a broad range of building efficiency stakeholders and building owners, including REITs, by allowing allocation of the deduction to parties connected with the relevant building expenditures, such as tenants, architects, and contractors. Further, with respect to REITs in particular, S. 3591 would have modified the REIT earnings and profits (E&P) rules so that REIT shareholders could realize the benefit of the increased deductions from the REIT's taxable income.[17]

4. Just as TRA 86's Retroactive Treatment of Real Estate Resulted in a Decline in Real Estate Values and Damage to the Economy, the Discussion Draft's Proposals Regarding Real Estate Could Result in a Similar Decline

The Discussion Draft's proposed repeal of the like kind exchange rules for real estate exchanges, imposition of ordinary income tax rates on depreciation recapture, and extension of the real

[16] Costs of saved energy ("CSE") per kilowatt hour ("kWh") for energy efficiency programs range from 2 cents to 3 cents per kWh. *See* American Council for an Energy Efficient Economy, "Saving Energy Cost-Effectively: A National Review of the Cost of Energy Saved Through Utility-Sector Energy Efficiency Programs" (September 1, 2009), available at http://www.aceee.org/research-report/u092.

[17] We note that the Obama Administration's FY 2013 Budget included a "Better Buildings Initiative" for converting section 179D to a credit designed to "encourage building owners and real estate investment trusts (REITs) to retrofit their properties." *See* White House Press Release (February 3, 2011) (available at http://www.whitehouse.gov/the-press-office/2011/02/03/president-obama-s-plan-win-future-making-american-businesses-more-energy). Because of the REIT distribution requirement, REITs generally do not have a tax liability; thus, a tax credit would not provide significant cost savings incentive for REITs to incur expensive efficiency costs. Thus, NAREIT submitted a comment letter on April 7, 2011 (available at http://www.reit.com/Portals/0/SubmissiontotheTreasury4-7.pdf) to the Treasury Department recommending potential alternatives for improving the cost-effectiveness of retrofitting activities, which could include the ability to assign and/or transfer the credit to third parties (including tenants and service providers); indefinite carry forward of the credit to offset any potential REIT-level tax liability (including, but not limited to, tax on retained net capital gains); and the conversion of the credit to an economically equivalent deduction modeled after existing section 179D, provided that existing E&P rules are revised so that REIT shareholders could realize the benefit of the increased deductions from the REIT's taxable income.

estate cost recovery period to 43 years would amount to a substantial increased cost to investing in and improving real estate without any corresponding benefit.

The effects of the increased costs imposed on the real estate industry by the TRA 86 and the ensuing damage to the real estate industry and the overall U.S. economy should be borne in mind when considering the proposals suggested in the Discussion Draft. Specifically, the TRA 86 enacted a number of changes applicable to the taxation of real estate investments (including limiting passive losses, lengthening cost recovery periods, the repeal of investment tax credits; the limitations on the deductibility of interest expense; and increasing marginal tax rates on ordinary income and capital gains), many of them retroactive in the sense that the new rules applied to investments made before the enactment of TRA 86.

Of particular concern to NAREIT is the retroactive application of many of the provisions of the Discussion Draft. Owning and operating real estate requires significant capital investment. Taxpayers that undertake such investment base their decisions based on the existing rules. The material and retroactive changes to these rules proposed by the Discussion Draft would be not only unfair to these taxpayers, but also would undermine their confidence in the “system,” and greatly diminish their likelihood to undertake additional investments based on the rules that supposedly apply, thereby affecting not only them, but also their shareholders or other investors who rely on their dividends or other income for retirement savings and income needs.

In fact, since the enactment of TRA 86, several studies have shown extensive adverse effects of these changes to the value of real estate. *See, e.g.*, Federal Deposit Insurance Corp. *History of the Eighties—Lessons for the Future.* Vol 1: *An Examination of the Banking Crises of the 1980s and Early 1990s* (1997) 138, 141[18] (“The consequences of these provisions was to dampen the demand for commercial real estate investments during the late 1980s and early 1990s, and the dampening of demand helped soften real estate prices”); Stanley D. Smith, Larry R. Woodward and Craig T. Schulman, *The Effect of the Tax Reform Act of 1986 and Overbuilt Markets on Commercial Office Property Values*; 19 J. REAL ESTATE RESEARCH 301, 317 (2000) (“The results indicate that the TRA86 did have a significant negative effect on values in all four regions [of the U.S.]”);[19] Stanley D. Smith and Larry R. Woodward, *The Effect of the Tax Reform Act of 1986 and Regional Economies on Apartment Values,* 11 J. REAL ESTATE RESEARCH 259, 270 (1994) (“results indicate that overall the Tax Act of 1986 had a *significant* negative impact on apartment values”)[20]; Gary C. Sanger, C. F. Sirmans and Geoffrey K. Turnbull, *The Effects of Tax Reform on Real Estate: Some Empirical Results*, 66 J. LAND ECONOMICS 409, 421 (Nov. 1990), (“results suggest that passage of the 1986 TRA had similar negative implications for both REITs and non- REIT real estate firms”).

[18] Available here: http://www.fdic.gov/bank/historical/history/137_165.pdf.

[19] “The estimated percentage losses are 10.1%, 10.4%, 14.7% and 17.1% for the East, Midwest, West and South, respectively.” *Id.*

[20] Emphasis added.

The adverse effects of the retroactive changes of TRA 86 on the real estate market should be kept in mind when considering significant and retroactive tax changes.

5. Elimination of the Section 194 Deduction for Reforestation Expenses Would Discourage Forest Owners from Replanting Forests

The Discussion Draft proposes to repeal section 194, which currently provides an immediate deduction of up to $10,000 for reforestation costs (*e.g.*, replanting costs) per stand, with the remaining costs amortizable over seven years. Absent section 194's deduction, forest owners would need to capitalize and recover costs when the timber is harvested. Recovery of these costs could take 25-80 years on a per stand basis. Reforestation requires large amounts of investment capital. By helping keep private forests economically viable, section 194 helps enable forest owners to make investments that provide a broad array of societal and environmental benefits. These benefits include reducing carbon in the atmosphere, protecting soil, creating wildlife habitat, maintaining water quality and providing open space for recreation.

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Thank you for the opportunity to submit these comments. Please contact me at (202) 739-9408 or tedwards@nareit.com or Dara Bernstein, NAREIT's Senior Tax Counsel at (202) 739-9446 or dbernstein@nareit.com, if you would like to discuss these issues in greater detail.

Respectfully submitted,

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cc: The Honorable Orrin Hatch