



April 10, 2015

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

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

The Honorable John Thune
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Benjamin Cardin
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Hatch, Ranking Member Wyden, Senator Thune and Senator Cardin:

Thank you for the opportunity to provide the Senate Finance Committee, and the Working Group on Business Income Tax Reform, with our comments and recommendations regarding the important matter of comprehensive tax reform. NAIOP, the Commercial Real Estate Development Association, is the leading organization for developers, owners, investors, and related professionals in office, industrial and mixed-use real estate, with 15,000 members and 47 local chapters throughout the United States. We hope that these comments, made on behalf of our members in the commercial real estate industry, will help in your efforts to develop a tax code that is fairer, simpler, and geared toward stronger economic growth that benefits all Americans.

The commercial real estate development industry, including financing, construction, and operation, plays an enormous role in our nation's economic life. Direct construction spending and related economic impacts generate a significant financial contribution to state and local economies. New commercial projects provide jobs during their initial construction phase. The impact of commercial real estate development, however, is felt far beyond the time when construction is completed. These new buildings represent a permanent expansion of the productive capacity of the communities in which they are located. The job growth and income generated by annual building operations represent a continuing infusion of funds into local, state and national economies that accumulate over time, growing in importance. Our financial institutions hold trillions of dollars in commercial real estate-related debt, magnifying the importance of the continued economic health and vitality of the industry to the overall economy.

Because of the critical importance of the commercial real estate to our economy, how a comprehensive revamp of our tax code affects our industry will also have far-reaching implications for our nation. While the expectation that simplification of our tax code, coupled



with reductions in overall tax rates, will lead to greater capital formation, encourage entrepreneurship, and lead to greater economic growth, the reality is that on prior occasions comprehensive tax reform has caused unintentional damage to our industry and the economy. The 1986 Tax Reform Act, signed by President Reagan, created serious economic dislocations in the real estate sector, primarily through a retroactive application of tax changes to existing investments. This caused a severe downturn in commercial real estate markets in the late 1980s, which contributed to the subsequent savings and loan crisis and an eventual bailout by the U.S. taxpayer, as well as a “credit crunch” which plagued real estate credit markets thereafter. Having learned these lessons of history, we hope that proper importance and consideration is given to providing adequate transitions for those already invested in commercial real estate, so as not to short circuit your ultimate goal of growing our economy and creating jobs.

Today, many in Congress want to reform the tax code with an eye toward reducing our corporate tax rates in order to increase the international competitiveness of our businesses. This is a worthwhile goal, and the current high tax rate on corporate income does undermine our ability to compete in the global economy. But policymakers should also resist making changes that could negatively affect a major sector of the economy solely for the purpose of offsetting costs of tax rate reductions for corporations. The primary business entity form in the commercial real estate industry is the pass-through – partnerships, limited liability companies and sole proprietorships, which would not benefit directly from a corporate rate reduction. As a general principle, tax policy provisions should be assessed and changes made to existing laws because such actions are the right tax policy over the long-term, and not for short-term budgetary reasons or to offset the costs of other changes.

Reforming our nation’s overly complex tax code in the right manner can lead to a more dynamic economy by lowering rates, reducing compliance costs, and providing flexibility for our nation’s entrepreneurs. Broadly speaking, we believe those worthy goals can be accomplished by adhering to the following organizing principles when developing reform proposals:

- Promote economic growth and support capital formation. Our tax code should encourage entrepreneurship and responsible risk-taking. Maintaining a differential between investment income and ordinary income rewards those who take the risks that add vitality to our economy and lead to long-term economic gains. Tax law should facilitate and not hinder the ability of businesses to expand to meet potential future needs and opportunities.
- Recognize the true economic life of assets for cost recovery purposes. Rules governing cost recovery and depreciation of structures and assets should be based on how long such assets actually last in the marketplace, before needing replacement or becoming outdated and obsolete. Depreciation schedules that do not accurately reflect the true useable life of assets create disincentives for additional capital investment needed to replace or upgrade these assets.



- Provide stability and predictability, creating a more favorable investment environment. Temporary tax provisions that are good policy should be a *permanent* part of the tax code, and not be subject to short-term, congressional reauthorizations. Doing so would ensure that businesses can better plan for the future, and investors can move forward confidently with long-term investment decisions that otherwise might be too risky if tax policy is uncertain or subject to frequent change.
- Support investments that help achieve broadly-supported public policy goals. Perfect tax code neutrality should lead to the elimination of any tax considerations from business decisions. In a few instances, however, economic realities, upfront costs and return on investment calculations prohibit businesses from achieving broadly-supported societal goals, such as advanced levels of building energy efficiency. The tax code should maintain incentives to support efforts that help businesses overcome existing market barriers.
- Provide for adequate transition rules. Tax reform changes should take into account existing investment relationships and the impact of these changes on business entities, and provide fair and adequate transition periods designed to minimize economic dislocation. The impact of tax policy changes should be prospective, not retroactive, to the extent possible.

From the perspective of those in the commercial real estate industry, and on behalf of NAIOP members, we believe a proper application of these principles makes it more likely that efforts at tax reform will not only result in a plan that benefits our nation broadly, but also increases vitality and growth in our industry. With those two goals in mind, we offer the following observations and recommendations regarding several matters of particular importance to the continued health of our nation's commercial real estate industry.

Like-Kind Exchanges (Section 1031)

Recent tax reform proposals would have eliminated or severely constrained the ability to defer taxes on the exchange of like-kind properties, as provided under current Section 1031 of the tax code. For nearly 100 years, our tax laws have recognized the principle that exchanging investment property, or property used in a business, for like-kind property results in no change in economic position, and therefore should not give rise to a taxable event. Section 1031 of the Internal Revenue Code embodies this principle, recognizing that taxpayers exchanging like-kind property have not altered either the type or level of their investment and that the economic situation of the taxpayer has not changed.

For commercial real estate, which is essentially an industry whose products are long-lived capital assets, past depreciation deductions often magnify the tax impact of transferring ownership of a structure. The tax liability associated with a sale of the property creates a "lock-in" effect on



owners wishing to transfer their property. Absent the ability to defer those taxes through a 1031 exchange, many real estate transactions will not occur.

Deferral of gain also allows owners to transfer property to those who are able to invest capital to make needed upgrades and improvements, or make other changes that allow the property to be put to its best use. Practically speaking, eliminating the ability to defer gain on like-kind property exchanges would increase the likelihood that current owners, who may not be capable of investing the capital needed for repairs and maintenance, cannot transfer the property due to the tax liability.

In modern commercial real estate markets, the ability to exchange properties using Section 1031 provides the flexibility that allows real estate owners to allocate capital to its most productive uses, including repositioning their portfolios and improving operations by realigning properties geographically or by product type. Like-kind exchanges contribute to the efficient functioning of modern commercial real estate by enabling capital to flow more freely among real estate investments, and often provide the liquidity to make deals work.

By ensuring the proper and efficient functioning of real estate markets, and by facilitating needed investment in real estate improvements, like-kind exchanges promote job growth and community development, and should be maintained as a feature of any tax reform proposal given serious consideration by the Senate Finance Committee.

Carried Interests

In the real estate context, a “carried interest” (also known as a “promoted interest”, or a “promote”) is simply compensation that is given to a general partner by the investors in a venture that exceeds the proportionate share of capital from the general partner. Carried interests and promotes have been a feature of the commercial real estate development industry for many years. They are given primarily to align the interests of the general partner with those of the investors, so that the general partner has a vested interest in the long-term success of the project. They are also given to compensate for all the risks undertaken by a general partner in a real estate development deal, including liability for all partnership liabilities, such as environmental contamination and lawsuits, and for guarantees of construction completion and payment of debts.

Carried interest compensation has historically been treated for tax purposes as capital gains. Over the last several years, proposals have been introduced in Congress to change the tax treatment of carried interests, from capital gains to ordinary income taxable at much higher rates. Part of the motivation behind these proposals reflected the belief that many who received carried interest compensation, and in particular those in the hedge fund business, were not taking risks but in fact were performing services. As a result, their income was thought to be more in the nature of salary – guaranteed, than capital gains.



For a variety of reasons, this logic does not apply in the real estate development context. A general partner in a real estate venture is at risk for not only for any capital contributions to the partnership, but also the aforementioned risks involved with a development project. Because payment of carried interest compensation is dependent on the ultimate success of the real estate development venture, and is paid only after certain investment hurdles have been cleared and investor partners have been compensated, it is far from being *guaranteed* income. As a consequence, a general partner's carried interest is really more in the nature of a capital gain, and should not be compared to guaranteed salary taxable at ordinary income rates. Real estate development itself also involves a capital asset, which remains in the community, making ongoing contributions to the economy. For all of these reasons, carried interests in real estate are more analogous to capital gains income than to ordinary, salaried income.

Changing the tax treatment of carried interests would have a retroactive impact and disrupt the existing investment relationship between many entrepreneurs and their capital finance partners. Reducing incentives for entrepreneurs to undertake the risks inherent in development would have a pronounced negative impact on the real estate industry, and would also limit the flow of investment capital to the real estate industry. Failing to afford capital gains treatment for real estate partnership carried interests would do nothing to promote economic growth, create jobs, or further capital formation, but in fact would undermine all of these goals.

Recognizing the unique and long-term character of real estate investment, and the critical role played by carried interests in compensating entrepreneurial risk-taking in development, former House Ways and Means Committee chairman Dave Camp specifically excluded real estate from any change in the tax treatment of carried interest.

Depreciation of Structures and Leasehold Improvements

Today's commercial real estate markets must be responsive to swiftly changing economic conditions in communities throughout our nation. Moreover, rapid technological change in building design contributes to buildings becoming obsolete in the marketplace much more quickly than in the past. For their part, tenants are requiring ever-changing office and warehouse configurations which demand increased capital investment.

Cost recovery and depreciation rules for long-term investments should strive to approximate as accurately as possible the true economic lifespan of assets, and account for their decline in value over time. Unfortunately, tax proposals introduced in the last Congress in both the House and Senate would have gone in the opposite direction, lengthening depreciation schedules for structures and their component parts far beyond their reasonable economic usefulness. In one case, depreciation for all real property would have been lengthened to 43 years, an increase from the statutory 39-year period for commercial buildings, and from the 15-year period for leasehold improvements provided for in temporary tax provisions that are periodically renewed by Congress.



Until 2004, the Internal Revenue Code required that depreciation for leasehold improvements – the customized improvements a building owner makes to a rental space to configure it for a tenant’s needs, occur over the economic life of the building structure itself (39 years), rather than over the economic life of the improvements. In 2004, Congress temporarily reduced this period to 15 years – a period much closer to the useful life of leasehold improvements. This 15-year depreciation schedule is subject to reauthorization in tax extenders bills. The provision expired at the end of 2013. At the close of 2014, Congress renewed 15-year qualified leasehold improvement depreciation, but only retroactively for calendar year 2014.

Clearly, leasehold and tenant improvements do not last for nearly four decades as contemplated by some of the cost recovery proposals made in the last Congress. Even at 15 years, the depreciation schedule provided under law extends beyond the true economic lifespan of today’s tenant build-outs. In fact, in modern commercial real estate markets, leasehold improvements characteristically last *only five to ten years across all commercial sectors*, or the average length of a lease term.

Longer depreciation periods result in higher capital costs for building owners, creating disincentives to upgrade and modernize the space for their tenants. And increased investment in leasehold improvements has substantial positive impacts upon economic growth. In 2014, leasehold improvement outlays of roughly \$30.4 billion added nearly \$93.7 billion to the U.S. economy, and supported over 710,000 jobs.¹ Stated simply, lengthening depreciation schedules beyond the realistic useful life of the assets unnecessarily reduces investment in real property, and costs jobs that otherwise would result from upgrading and modernizing tenant spaces.

In addition, having to extend 15-year qualified leasehold improvement depreciation periodically in tax extenders bills creates needless uncertainty for the commercial real estate industry, and creates disincentives for owners to upgrade tenant space. While even 15-years is beyond the usual lifespan of most leasehold improvements, this period reflects much more closely the economic reality of the modern commercial real estate market than the statutory 39-year period under current law.

While we believe Congress should provide for depreciation periods that reflect the true economic lifespan of capital assets, at the very least Congress should, in any tax reform proposal, make permanent 15-year depreciation for qualified leasehold improvements. More closely matching depreciation to the true useful life of the asset, and creating a more favorable investment environment by increasing predictability and stability of tax law, would lead to increased investment in our structures, and economic and job growth in our communities.

¹ Economic Impacts of Commercial Real Estate, 2015 Edition, Submitted by: Stephen S. Fuller, PhD Dwight Schar Faculty Chair and University Professor; Director, Center for Regional Analysis, George Mason University, Arlington, Virginia.



Energy Efficient Commercial Building Incentive

Becoming more energy-efficient is an important consideration in today's commercial real estate industry. Developers want to build and market, and tenants want to occupy, energy-efficient space both to lower costs, and because it is seen by most as being more socially conscientious and environmentally-friendly. However, in the real estate industry, local economic conditions determine the levels of efficiencies and costs that can be absorbed in a given market. The upfront costs for many energy efficient technologies and building systems cannot be recouped by energy savings or rental income in an amount of time needed to justify those investment decisions. Typically profitable investments in energy efficiency need to be recouped in less for five years.

In limited cases, where there is broad consensus on important issues of public policy and where tax incentives can address market limitations that undermine achievement of these goals, then we believe providing support through the tax code is appropriate. We contend that increasing energy efficiency, which can strengthen our nation's energy independence falls under that category.

The Energy Efficient Commercial Building Tax Deduction, commonly referred to as Section 179D, provides an incentive for commercial buildings to install high performance energy systems that go beyond existing energy building code requirements. It allows building owners to recover returns on their investments more quickly. It is the only direct federal incentive designed to assist commercial building owners in recovering some of the costs for high-efficiency components and systems. Originally enacted by the Energy Policy Act of 2005, the incentive allows for a tax deduction of up to \$1.80 per square foot to owners of existing and new buildings who install energy-efficient building components that reduce a building's total energy consumption by at least 50 percent above the current building code.

The incentive expired at the end of 2014. We believe it is vitally important that Section 179D be renewed, and that it be included in any tax reform proposals as a permanent feature of our tax code. In order to make the incentive more effective, we suggest that it be converted to a tax transferable credit, and that the monetary amount of the incentive be increased from \$1.80 a square foot to \$3.00. In addition, further changes should be contemplated to the incentive to make it useable for Real Estate Investment Trusts that cannot take advantage of a deduction due to their tax structure.



Thank you for the opportunity to offer our recommendations on comprehensive tax reform, and for your consideration of the approach we suggested on matters of importance to commercial real estate. We applaud the efforts of you and all of the members of the Senate Finance Committee as you move forward toward a simpler, fairer tax code that promotes economic growth and opportunity.

Please be assured that as you go forward, NAIOP will continue to work with you, members, and the staff of the Senate Finance Committee to ensure that future tax policy remains supportive of the economic health of the commercial real estate industry.

Sincerely,

A handwritten signature in black ink, reading "Thomas J. Bisacchino". The signature is fluid and cursive, with the first letters of the first and last names being capitalized and prominent.

Thomas J. Bisacchino
President and CEO