TAX REFORM

THE PERSPECTIVE OF THE RETAIL REAL ESTATE INDUSTRY

ICSC supports the goals of comprehensive tax reform to lower rates, simplify the tax code, and grow the U.S. economy. However, many of the changes that have been proposed have the potential to significantly affect the retail real estate industry.

The last major tax reform in 1986 represented the largest ever tax imposed on the real estate industry. The law had a considerable detrimental effect on our businesses and the U.S. economy, from which it took years to recover.

KEY ISSUES FOR TAX REFORM

Transition Rules

The most damaging aspect of the 1986 Tax Act was that the major changes to the taxation of real estate were applied retroactively to existing investment that had been made under previous and well-established tax rules. Without transition rules, our businesses nosedived, which had a cascading effect on U.S. markets – like the Savings and Loans Crisis – and dragged down the rest of our economy.

- **To prevent a repeat of 1986, Congress should include transition rules to prevent harm to existing commercial real estate investments.**

Border Adjustment Tax (BAT)

The Border Adjustment Tax is a completely new type of consumption tax. Economists have widely varying viewpoints on the effect of the BAT on the price of consumer goods, most of which are imported.

- **Given the uncertainty surrounding the proposal, Congress should oppose the BAT and focus on proven ways to increase jobs and grow the economy.**

Potential Change to the Treatment of Pass-through Entities

Pass-through entities are an integral part of the retail real estate business model. Two of the most widely-used models are partnerships and real estate investment trusts (REITs). Under the current law, pass-throughs are a more efficient business structure and provide liability protection for the owners, a single level of income taxation and the pass-through of gains and losses to the partners.

Any changes to the tax treatment of pass-throughs would have immediate and far-reaching implications for real estate because existing partnerships are based on previously agreed to contractual arrangements between the general partner and the limited partners.

- **ICSC supports efforts to ensure parity under the tax code for business income earned by pass-throughs and corporations.**
- **Congress should retain the lower capital gain rate to preserve the incentive to invest.**

Preserve Interest Deduction

Debt is essential for almost all businesses, large and small. Commercial real estate companies rely on access to reliable debt markets to finance investments to expand their business. Loans also provide needed liquidity to maintain the commercial properties in our communities or make payroll. Since its inception, the tax code has provided a deduction for interest paid.

- **Congress should retain the full deductibility of business interest payments to help businesses invest in our communities and create jobs.**

(Continued on reverse.)

Depreciation Rules

Depreciation and cost recovery are intrinsic aspects of commercial real estate investment decisions. The House proposal would allow full and immediate expensing of purchases of property. Previous tax reform proposals, however, recommended lengthening depreciation lives for real property to pay for lower tax rates.

- **Congress must not lengthen the depreciation for real estate, which would create a disincentive to invest or modernize existing development.**
- **Likewise, any proposal that provides full expensing could distort the market by increasing incentives to buy property for short-term tax benefits. Congress should carefully consider and address the potential impact on the real estate market before enactment.**

Shopping centers are a critical revenue source for local communities, generating billions of tax dollars that fund critical city infrastructure from fire departments and schools, to playgrounds and parks.

- **Local Property Taxes: $27.8 billion annually**
- **State and Local Sales Taxes: $167.3 billion annually**

Carried Interest

In a real estate partnership, carried interest is not compensation for services but recognition of the risk absorbed by the general partner. These risks can include environmental remediation, lawsuits, loan guaranties, construction completion, leasing, and responsibility for recourse debt. Developers may have to add their own capital into the deal if the value of their property declines.

The developer pays ordinary income taxes on the fees received for standard services such as leasing or construction management. Carried interest is only received if the project is successful and the investor partners (the limited partners) have received back their full investment plus a minimum "hurdle" rate of return.

- **Increasing taxes on carried interest would discourage development, especially in underserved markets and brownfield sites that have additional risks.**

State and Local tax Deduction

Real estate is the largest contributor to the local tax base. The deductibility of state and local taxes is grounded in the Constitution, federalism, and states' rights. The deduction prevents the federal government from double-taxing income that is already taxed at the state level.

- **Congress should retain the deduction for state and local taxes for businesses.**

Preserve Like-Kind Exchanges

Section 1031 like-kind exchanges are utilized widely in the retail real estate industry. This tax provision allows for the deferral of tax when a property is exchanged for another of "like kind" and allows for capital to be immediately reinvested.

Like-kind exchanges promote the efficient use of capital by allowing taxpayers to shift to more productive like-kind property, change geographic location, diversify or consolidate holdings, or otherwise transition to meet changes in business needs. Taxpayers ultimately recognize their taxable gain when they "cash out" of the asset, and therefore have resources available to pay the taxes.

- **Congress should preserve like-kind exchanges to support investment in our communities. Repealing like-kind exchanges would drastically reduce real estate sales activity, increase asset holding periods, and slow the rate of investment.**

For more information contact Phillips Hinch at phinch@icsc.org or 202-626-1402.