Federal Tax Policies Affecting Property Managers and Commercial Real Estate Brokers

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IREM Institute of Real Estate Management

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Introduction

A tax code that encourages investment is beneficial to IREM Members, their clients, and the health of our nation's economy. The IREM Legislative Department monitors legislation in Congress, as well as regulatory action by the Treasury Department. The federal tax code is constantly changing and growing more complicated, so members should work closely with a tax professional to make sure that they are taking full advantage of the many credits and deductions available to them.

For members who are interested in how the current set of tax policies came to be, as well as if, when, and how those policies may change, the Legislative Department Staff has prepared this primer. Questions about the specific impact that each statute or regulation could have on you or your company's finances should be directed to you tax professional.

Capital Gains

The appropriate level of taxation for capital gains (the amount realized when property held for investment is sold) has been a subject of tax policy debate throughout the history of the income tax. For at least 50 years (with the exception of the period from 1986 – 1990), capital gains have been taxed at rates well below the maximum tax rate for ordinary income. During the past 25 years that rate has ranged from a high of 49% to the current rate of 15% (this rate is set to expire on December 31, 2010). Since 1997, depreciation allowances taken in prior years are "recaptured" (or taken back into income") and taxed at 25% when investment real estate is sold. Prior to 1997, depreciation recapture amounts were taxed at the same rate as capital gains. Capital losses are deductible in full against capital gains. In addition, individuals may deduct up to $3,000 of capital losses against ordinary income in each year, with any remaining excess losses being carried forward to future tax years.

Position Statement

IREM believes that it is in our nation's best interest for Congress to encourage real estate investment in the United States by creating a tax system that recognizes inflation and creates a meaningful differential between the tax rates for ordinary income and those for capital gains. The Institute supports a level playing field for those who choose to invest in real estate and thus opposes rates for depreciation recapture that are higher than the capital gains rate. (see also *Depreciation*)

Other Sources

The Internal Revenue Service, U.S. Department of the Treasury
http://www.irs.gov/taxtopics/tc409.html

National Association of REALTORS® Issue Summary
http://www.realtor.org/fedistrk.nsf/0/86651a733e825bdd8525663c00586cb9?OpenDocument

Depreciation

The Economic Recovery Tax Act of 1981 created a depreciable life of 15 years for all real property placed in service after December 31, 1980. For property placed in service after March 15, 1984, the depreciable life was extended to 18 years, and for property placed in service after May 8, 1985, to 19 years. Depreciation rules changed again when the Tax Reform Act of 1986 was enacted. Depreciable life of a non-residential property changed to 31.5 years, and the depreciable life of a residential property changed to 27.5 years.

Yet again, the enactment of the 1993 Tax Act changed depreciable life for a nonresidential building to 39 years (residential property remained at 27.5 years). The 39-year depreciable life applies to properties placed in service on or after May 13, 1993. The extension of the depreciable life to 39 years was intended to be in return for favorable passive loss tax law and other tax law changes in 1993. Unfortunately, the Internal Revenue Service (IRS) did not interpret the 1993 law in such a way to be favorable to commercial real estate thereby eliminating almost any benefit to the commercial real estate industry.

Position Statement

The current 39-year time frame does not accurately reflect the useful life of a building and its components. IREM supports depreciation reform for nonresidential and residential real estate that secures a significantly shorter cost recovery period for commercial real estate without adding complexity or creating artificial acceleration of deductions and accurately reflects the economic life of the property. Furthermore:

1. Upon recognition of capital gain, taxpayers should be able to use sales costs basis to first reduce the depreciation recapture portion of the gain;

2. Suspended losses first go to reduce depreciation recapture;

3. An installment sale as gain is recognized over a period of time, that a percentage of gain from appreciation and depreciation recapture be used in reporting gain;

4. A partially tax deferred exchange, gain from appreciation and depreciation recapture should be reported on an allocated percentage basis.

5. Any other proposed regulation that affects the reporting of capital gain by commercial, industrial or investment real estate taxpayers be reported in the most advantageous manner for the taxpayer; and

6. Any proposed regulation that clarifies or makes easier the calculation of depreciation deductions under the "modified accelerated cost recovery system" when property is acquired in a like-kind exchange or as a result of an involuntary conversion shall be reported in the most advantageous manner for the taxpayer.

Tenant Improvements

The real estate definition of tenant improvement is money or any other financial incentive to a lessee, by the lessor, to cover, either partially or wholly, the cost of any structural changes (items such as upgraded electrical equipment, cable, reconfigured interior space, telecommunications equipment and technological updates) to a space in preparation for occupancy by the lessee.

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The cost for tenant improvements is amortized over the depreciable life of the nonresidential building, not, as in prior laws, over the term of the lease. The current depreciable life for a nonresidential building is 39 years, while the depreciable life of a residential property is 27.5 years. This 39 year depreciation applies to properties placed in service on or after May 13, 1993. In 2004, legislation was adopted that temporarily changed the amortization period for certain leasehold improvements to 15 years, with any remaining balance deductible at the end of the lease. This provision expired on December 31, 2005.

In another temporary provision enacted on March 9, 2002, landlords (or tenants – but not both) were able to deduct 30% of the cost of leasehold improvements in the year they are placed in service. This provision applied to improvements made between September 11, 2001 and September 11, 2004.

Position Statement

IREM is in support of legislation to decrease the length of depreciable lives for tenant improvements to the length of the lease term. IREM supports legislative language that would allow any remainder of tenant improvement costs left upon early termination of the lease to be written off upon the termination of a lease, not over the depreciable life of a structure.

Other Sources

The Internal Revenue Service, U.S. Department of the Treasury
http://www.irs.gov/businesses/small/article/0,,id=137026,00.html

National Association of REALTORS® Issue Summary on Depreciation
http://www.realtor.org/fedistrk.nsf/0/3197cdba53248b4a85256809005ab61c?OpenDocument

National Association of REALTORS® Issue Summary on Tennant Improvements
http://www.realtor.org/fedistrk.nsf/0/29367cbe3de5a848852566db00560fc7?OpenDocument

Passive Loss

The 1986 Tax Reform Act contained a provision known as passive loss limitation. These rules limited the amount of deductions for losses from passive activities to the amount of income those activities generate. Passive activities are defined as those in which a taxpayer does not materially participate in any rental activity. Thus, rental activity was deemed to be inherently passive even if rental activity is the principal business of the taxpayer, or is an integral part of the taxpayer’s real estate business.

The act was originally intended to broaden the tax base, and to abolish many existing tax shelters.

The Budget Reconciliation Act of 1993 included a passive loss tax law change. The intent of the new passive loss tax law was to allow individuals whose primary business is real estate to deduct rental property losses from their income. This was fair because other business professionals were permitted to deduct business losses from income. The act stated that in order to deduct passive losses from rental activity, an individual must be a material participant in the real estate trade or business, and spend more than 750 hours and a minimum of 50% of their time in various real estate activities.

The current problem lies with the final rules and interpretation of the legislation by the Internal Revenue Service. The regulations released in February 1995 by the IRS were unfavorable to the real estate industry. As written, these regulations still treated rental real estate activity differently than other real estate activity. Final rules on passive loss were released in December 1995. These rules were an improvement to those released earlier in the year, but there still exists a separation in the definition of rental real estate activity.

The intent of the new passive loss tax provision, which was released in December 1995, was to allow individuals whose primary business is real estate to deduct rental property losses from income. Retroactively effective January 1, 1995, these regulations state that a taxpayer that materially participates in rental activity does not necessarily have to interpret this rental activity as passive. Thus, losses on this activity can be used to offset nonpassive income.

Taxpayers must qualify in two ways. At least 750 hours must be spent in real estate activities in which the taxpayer materially participates and half the time annually must be spent in these real estate activities. Additionally, if the taxpayer works in the real estate field, he or she must own at least 5% of the business in order for the time worked to count (if the taxpayer is not 5% owner the entire year, the portion of the year that the taxpayer is 5% owner may be prorated for that time.)

Position Statement

IREM believes that active or material participants in real estate should be allowed to deduct all cash and non-cash rental losses against their other income and should be afforded the same benefits that other businesses have within the tax code. As part of the Budget Reconciliation Act of 1993, Congress qualified that real estate professionals who spend at least 750 hours and half their time annually in real estate activities will be permitted to use losses on rental real estate to offset any income.

The Institute urges the IRS to revise passive tax loss regulations to mirror the original intent of federal legislators in enacting a change made in 1993 to the passive loss tax law.

Other Sources

The Internal Revenue Service, U.S. Department of the Treasury
http://www.irs.gov/businesses/small/article/0,,id=146318,00.html

Real Estate Mortgage Investment Conduit (REMIC)

Real Estate Mortgage Investment Conduit (REMIC) is a tax vehicle created by Congress in 1986 to support the housing market and investment in real estate by making it simpler to issue real estate backed securities. REMICs are essentially the vehicle by which loans are grouped into securities. As of September 30th, 2003, the value of single family, multifamily, and commercial –mortgage backed REMICs outstanding was over $1.2 trillion.

While the current volume of REMIC transactions reflects their important role in this market, certain changes to the tax code will eliminate impediments and unleash even greater potential. Of all outstanding securitized debt, roughly a quarter is attributable to commercial loans. The securitization of commercial loans is viewed as unattractive to borrowers because of the limitations the federal rules place on the loan once it is securitized. Current rules that govern REMICs often prevent many common loan modifications that facilitate loan administration and ensure repayment of investors. For example, it is difficult for a mall, whose mortgage is held as part of a REMIC, to demolish a portion of the building to construct space for a new anchor store. Under current rules, for any change to collateral, a property owner must obtain a tax opinion. If the opinion finds that more than 10% of the collateral is modified, the renovation cannot go forward.

While REMICs have been instrumental in increasing the flow of capital to residential properties, the rules governing loan modifications have had a dampening effect on the securitization of commercial loans. Because securitization contributes to the efficiency of and liquidity of the secondary market for mortgage loans, it is hoped that changing the REMIC rules will lower the cost of commercial real estate borrowing and spur real estate development and re-habilitation. In recent years, several bills have been introduced to modernize REMIC rules.

Position Statement

IREM supports legislation that amends the REMIC rules to allow more common modifications to property. The changes would allow for, among other things:

- Preparing space for tenants (Tenant expansions and building additions): Under the proposed change, tenant improvements would not be considered a significant modification. Under current rules, a tax opinion must be obtained before demolishing/tenant improvements begin. If the space comprises more than 10% of the REMIC collateral, the change could be denied.

- Special problems for retail space: Under the proposed change, landlords could more easily reconfigure space to accommodate large anchor tenants and their requirements that only specific types of tenants occupy adjoining space so that instances where space "goes dark" because lease agreements could not be met are minimized.

- Sale of adjoining parcels: The proposed change would allow the sale of adjacent property that does not have any economic value to the landlord. Under current rules a tax opinion is necessary to determine whether sale materially alters the collateral --if it does, the sale would be blocked, even though the proceeds would be used to bolster reserves as required by the lender or pay down the loan.

- Addition of collateral to support building renovations and expansions: The proposed change would allow the posting of additional collateral in connection with the demolition or expansion of a property.

In amending the rules, modifications to a qualified mortgage would be allowed, provided:

1. The final maturity date of the obligation may not be extended, unless the extension would not be a significant modification under applicable regulations;
2. The outstanding principal balance of the obligation may not be increased other than by the capitalization of unpaid interest; and
3. A release of real property collateral may not cause the obligation to be principally secured by an interest in real property, other than a permitted defeasance with government securities.

The alteration may not result in an instrument or property right that is not debt for federal income tax purposes.

Other Sources

The Internal Revenue Service, U.S. Department of the Treasury
http://www.irs.gov/publications/p938/ar02.html

National Association of REALTORS® Issue Summary
http://www.realtor.org/fedistrk.nsf/0/5a5a49bf28b5922d85256e760075839d?OpenDocument

Energy Efficiency Tax Credit

The economic factors of supply and demand of energy resources surround the current debate of the nation's energy crisis. Efforts to create legislation on energy production and conservation were the focus of policymakers in the 109th Congress. H.R. 6, the Energy Policy Act of 2005, which the president signed H.R. 6 into law on August 8, 2005, included the Energy Efficient Commercial Buildings Deduction. This provision allows a deduction for energy efficient commercial buildings that reduce annual energy and power consumption by 50 percent compared to the American Society of Heating, Refrigerating, and Air Conditioning Engineers (ASHRAE) standard. The deduction will equal the cost of energy efficient property installed during construction, with a maximum deduction of $1.80 per square foot of the building. Also, a partial deduction of 60 cents per square foot would be provided for building subsystems.

Position Statement

IREM supports the concept of conservation policies and the use of energy efficient technology in building design and construction. However, we oppose mandatory national standards for building energy conservation. Instead, IREM encourages positive incentives for conservation activities such as energy tax credits and an increased emphasis on energy efficient technology by the nation's building industry.

In this growing economy, it is vital that consumers (both individual and business) have access to reliable, reasonably priced energy. The Institute encourages its members to conserve energy and reduce demand in their facilities. We encourage voluntary participation in programs such as EPA's Building Program, Green Lights Program, and Energy Star Program.

Other Sources

The Internal Revenue Service, U.S. Department of the Treasury
http://www.irs.gov/newsroom/article/0,,id=158395,00.html

National Association of REALTORS® Issue Summary
http://www.realtor.org/GAPublic.nsf/pages/retaxincentives

Historic Preservation Tax Incentives

Historic buildings are tangible links with the past. They help give a community a sense of identity, stability and orientation. The Federal Historic Preservation Tax Incentives program is one of the Federal government's most successful and cost-effective community revitalization programs. The Preservation Tax Incentives reward private investment in rehabilitating historic properties such as offices, rental housing, and retail stores. Current tax incentives for preservation, established by the Tax Reform Act of 1986 include:

- A tax credit equal to 20% of the amount spent on the certified rehabilitation of certified historic structures.
- A 10% tax credit for the rehabilitation of non-historic, non-residential buildings built before 1936.

A certified historic structure is a building that is listed individually in the National Register of Historic Places —OR— a building that is located in a *registered historic district* and certified by the National Park Service as contributing to the historic significance of that district. The 20% credit is available for properties rehabilitated for commercial, industrial, agricultural, or rental residential purposes. A *certified rehabilitation* is a rehabilitation of a *certified historic structure* that is approved by the NPS as being consistent with the historic character of the property and, where applicable, the district in which it is located.

The 10% rehabilitation tax credit is available for the rehabilitation of *non-historic buildings* placed in service before 1936, and applies only to buildings rehabilitated for *non-residential* uses. Rental housing would thus not qualify. Hotels, however, would qualify. They are considered to be in commercial use, not residential.

Other Sources

National Park Service online brochure, Historic Preservation Tax Incentives
http://www.cr.nps.gov/hps/tps/tax/brochure1.htm

Brownfields Deduction (Currently Expired)

Brownfields are defunct, derelict, or abandoned commercial or industrial sites, often tainted by the presence or potential presence of hazardous substances, pollutants, or contaminants.

In August 1997, the Federal Brownfields Tax Incentive was created as part of the Taxpayer Relief Act, permitting environmental cleanup costs associated with brownfields to be deducted in the year the costs are incurred. This incentive was temporary, and the most recent extension expired in 2005. As a result the full cost of cleanup once again must be capitalized into the cost of the land and cannot be recovered until the property is sold.

Position Statement

The federal government should continue to provide adequate funding for cleanup and redevelopment of our nation's brownfields sites and enhance the cost recovery of environmental remediation and cleanup expenditures by providing either current deduction or short amortization periods for those costs.

TAX	CURRENT LAW	LEGISLATIVE/REGULATORY STATUS/OUTLOOK	INSTITUTE POSITION
CAPITAL GAINS	Capital gains are taxed at a maximum rate of 15%. Depreciation recapture is taxed at a rate of 25%.	The current 15% rate will revert to 20% as of January 1, 2011 if Congress does not act. The depreciation recapture rate is presently 25%. Unless it is changed, it will remain at 25% as of 2011.	It is in our nation's best interest for Congress to encourage real estate investment in the United States by creating a tax system that recognizes inflation and creates a meaningful differential between the tax rates for ordinary income and those for capital gains. The Institute supports a level playing field for those who choose to invest in real estate and thus opposes rates for depreciation recapture that are higher than the capital gains rate.
CARRIED INTEREST	A common practice among real estate partnerships is to permit the general partner to receive some of the profits through a "carried interest." The general partner's profits interest is "carried" with the property until it is sold. When the property is sold, the general partner receives the value of its carried interest as capital gains income.	House Ways and Means Committee Chairman Charlie Rangel has indicated that "everything is on the table" as part of his plan to restructure the current tax code. This could mean eliminating the current capital gains treatment for any carried interest of a real estate partnership. Thus, the tax rate on income from a carried interest could increase from 15% to a maximum of 35%. No effective date has been proposed, leaving open the possibility that the tax-writing committees will be seeking new revenue sources throughout 2009 and 2010.	By increasing the tax burden on real estate partnerships, an increase in the carried interest tax rate would make real estate a less attractive investment. We oppose any proposal that would eliminate capital gains treatment for any carried interest of a real estate partnership.
DEPRECIATION	The enactment of the 1993 Tax Act changed depreciable life for a nonresidential building to 39 years (residential property remained at 27.5 years). The 39-year depreciable life applies to properties placed in service on or after May 13, 1993.	The extension of the depreciable life to 39 years was intended to be in return for favorable passive loss tax law and other tax law changes in 1993. Unfortunately, the Internal Revenue Service (IRS) did not interpret the 1993 law in such a way to be favorable to commercial real estate thereby eliminating almost any benefit to the commercial real estate industry. Depreciation may become part of the tax overhaul debate this year, however, there are currently no proposals related to depreciation.	The current 39-year time frame does not accurately reflect the useful life of a building and its components. The Institute supports depreciation reform for nonresidential and residential real estate that secures a significantly shorter cost recovery period for commercial real estate without adding complexity or creating artificial acceleration of deductions and accurately reflects the economic life of the property.
INCOME TAX	The 2001-2003 Bush tax cuts included tax reductions in the federal income tax brackets, which included a 33 and 35 percent rate for the top two income	Falling tax revenues and increased government spending due to the economic crisis have put lawmakers under pressure to seek new revenue	The Institute supports tax policy that would encourage investment in the commercial real estate industry.

	brackets. If Congress does not act, on January 1, 2011, the current 33 percent rate will revert back to 35 percent and the current 35 percent rate will increase to 39.6 percent.	sources. This could mean allowing the income tax reductions in the 2001-2003 Bush tax cuts to expire in 2011 or possibly repealing some of these tax cuts before their expiration date. President Obama's pledge not to raise taxes on the middleclass makes it likely that the Democratically-controlled Congress will discuss increasing the top two income rates or allowing them to expire in 2011. If the top two income tax rates increase, less money will be available for high income earners to invest in commercial real estate, putting more pressure on the industry.	
Leasehold Improvements	The Emergency Economic Stabilization Act of 2008 extended the 15-year straight-line cost recovery for qualified leasehold improvements through January 1, 2010 for property placed in service after December 31, 2007. It also extended the 15-year cost recovery period for depreciation of certain improvements to retail space through January 1, 2010 for property placed in service after December 31, 2008.	Currently there are no opposing views about the merits of a 15-year cost recovery period for qualified leasehold improvements. Also, Congress has reached a consensus that a 39-year recovery period is too long. An extension of the 15-year recovery period will likely be debated against other tax cuts because of its cost to the federal government.	A 39 year depreciable life for tenant improvements is unrealistic. A realistic cost recovery period, such as 10-15 years, provides an incentive for building owners to upgrade and improve their space.
Passive Loss	As part of the Budget Reconciliation Act of 1993, Congress qualified that real estate professionals who spend at least 750 hours and half their time annually in real estate activities will be permitted to use losses on rental real estate to offset any income. Individuals may also qualify if the taxpayer works in the real estate field, he or she must own at least 5% of the business in order for the time worked to count (if the taxpayer is not 5% owner the entire year, the portion of the year that the taxpayer is 5% owner may be prorated for that time.) Furthermore, in order to protect individual investors, the passive loss rules included an	While House Ways and Means Committee Chairman Charlie Rangel has indicated that "everything is on the table" as part of his plan to restructure the current tax code, at the moment passive loss rules have not yet been part of the overhaul debate.	The Institute believes that active or material participants in real estate should be allowed to deduct all cash and non-cash rental losses against their other income and should be afforded the same benefits that other businesses have within the tax code. The Institute urges the IRS to revise passive tax loss regulations to mirror the original intent of federal legislators in enacting a change made in 1993 to the passive loss tax law, specifically removing the 5% ownership provision. Additionally, the Institute urges the IRS to index the exception rules for inflation.

	exception to assure that individuals with moderate incomes could continue to invest in real estate as individual owner-landlords. Under the exception, an individual with less than $100,000 of adjusted gross income (AGI) could deduct up to $25,000 of losses from rental real estate from other non-real estate income. The amount of rental losses that an individual can write off is proportionately phased out between $100,000 and $150,000. For example, if an individual's adjusted gross income is $125,000, he/she can write off $12,500 in rental losses in the year of the loss. If an individual is an active participant and his/her adjusted gross income is $150,000 or more, he/she can write off no rental losses on his/her tax return in the year of the loss. The exception was not indexed for inflation. Had it been indexed for inflation, the adjusted AGI amount would now be $182,495 and the phase out at $150,000 would now be $273,742. In addition, the $25,000 cap on allowable losses would now be $45,624. The failure to index has had the effect of diminishing the pool of likely investors who would operate as real estate investors or part-time landlords. On top of this, inflation has not kept pace with real estate prices, so the gap is even greater.		
REAL ESTATE MORTGAGE INVESTMENT CONDUIT (REMIC)	Real Estate Mortgage Investment Conduit (REMIC) is a tax vehicle created by Congress in 1986 to support the housing market and investment in real estate by making it simpler to issue real estate backed securities. REMICs are essentially the vehicle by which loans are grouped into securities. Regulations implemented over 15 years ago limit commercial property owners with securitized mortgage to reposition their property to meet changing economic trends.	On September 15, 2009, the U.S. Department of Treasury issued final guidance for commercial mortgage loans held by a Real Estate Mortgage Investment Conduit (REMIC). Under the new guidance, Revenue Procedure 2009-45 describes the conditions under which modifications to certain mortgage loans will not cause the IRS to challenge the tax status of REMIC's or investment trusts. In other words, the guidance increases the flexibility given to servicers to modify commercial mortgages within a REMIC by allowing	The Institute supports legislation that amends the REMIC rules to allow more common modifications to property in order to make securitization more attractive to commercial borrowers. Updated IRS guidelines should provide much needed flexibility for owners with properties utilizing REMICs and facilitate better communication and planning between the servicer and the borrower.

		special servicers to make significant modifications without the REMIC losing its tax-free status. Moreover, the new guidelines permit a change in the terms to be negotiated if, based on all the facts and circumstances, and after meeting the threshold for a qualified loan, the holder or servicer reasonably believes there is a "significant risk of default" of the loan upon maturity of the loan or at an earlier date, and that the modified loan will present a substantially reduced risk of default. Furthermore, the IRS issued final regulations under 1.860G (T.D. 9463) expanding the list of exceptions that will not be considered "significant modifications" of an obligation held by a REMIC. The final regulations issued expands the list of permitted exceptions to include changes in collateral, guarantees and credit enhancement of an obligation as well as changes to the recourse nature of an obligation. No further REMIC regulation or legislation is currently proposed.	
TAX ISSUES WITHOUT STATEMENTS OF POLICY	**CURRENT LAW**	**LEGISLATIVE/REGULATORY STATUS/OUTLOOK**	**HOW THIS ISSUE AFFECTS YOU**
ALTERNATIVE MINIMUM TAX (AMT)	The AMT was created in 1969 to prevent a small number of wealthy Americans from evading paying taxes. Over the years the AMT has come to affect more people every year because it is not indexed for inflation. The Emergency Economic Stabilization Act of 2008, enacted on October 3, 2008, provides Alternative Minimum Tax (AMT) relief for the 2008 tax year.	In October 2008, the Emergency Economic Stabilization Act was signed into law. This legislation included a temporary "patch" provision that prevented most middle income tax payers during the 2008 tax year. However, if Congress does not act soon, millions of middle class Americans could pay more taxes for the 2009 tax year.	The Emergency Economic Stabilization Act of 2008 prevented an estimated 26 million Americans from having to pay more during the 2008 tax year. Present AMT rules are complex and burdensome.
