Anderson Gerald C

From: Julie Skelton [JSkelton@taxreformpanel.gov]
Sent: Sunday, April 03, 2005 3:20 PM
To: IRS Comments
Subject: general - organization/association

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-----Original Message-----
From: Steve Renna [mailto:srenna@rer.org]
Sent: Monday, February 28, 2005 3:39 PM
To: comments
Subject: Real Estate Roundtable comments

The President's Advisory Panel on Federal Tax Reform
1440 New York Avenue NW
Suite 2100
Washington, DC 20220

Dear Chairman Mack and Vice Chairman Breaux:

I am pleased to submit to the Advisory Panel the enclosed report prepared by the accounting firm of Deloitte entitled "Tax Reform: An Introduction to the Options and Their Effects on Real Estate". The Real Estate Roundtable commissioned this report in order to gain a better understanding to the leading tax system reform options and how they might generally affect the real estate industry.

The Real Estate Roundtable is a federal policy organization comprised of the chief executive officers of the leading real estate companies in the country and the elected leaders of the major real estate trade associations. We believe this report will be of benefit to the Advisory Panel in fostering an appreciation of the big picture tax and economic effects each of these tax reform options could have on investment real estate owners, homeowners, investors and lenders.

Real estate is a vital sector of our economy. According to the Bureau of Economic Analysis, in 2001 real estate's contribution to the Gross Domestic Product was $2.9 trillion, almost one-third of our nation's total GDP. Real estate asset values today are nearly $5 trillion. We urge the Advisory Panel to consider carefully how real estate, both commercial and residential, is affected by the various tax reform options as it shapes its final recommendations to President Bush.

The report does not draw concrete conclusions about the various tax reform proposals since their details are too few to analyze and it would be premature to do so at this point. However, the report effectively demonstrates that fundamental tax reform will mean major changes for real estate -- some positive and some negative.

For certain, no matter what system is adopted, of paramount importance for real estate is that there be adequate transition rules from the old system to the new. Real estate is a long-lived asset and many investments will bridge the current tax system and any new system that is enacted. Transition rules must adequately account for this to avoid market disruption, valuation distortions and unfairness. As Fred Goldberg noted in his February 16, 2005 testimony to the Advisory Panel, "Transition rules matter. The 1986 Act contributed to the sudden and significant declines in real estate values."

The Real Estate Roundtable looks forward to assisting the Advisory Panel in its mission. We are available to provide you with information in addition to this report and request an opportunity to testify at a future hearing of the Advisory Panel.

If you have any questions or comments, please do not hesitate to contact me or Roundtable Senior Vice President and Counsel Steve Renna. Thank you.

Sincerely,

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The Real Estate Roundtable

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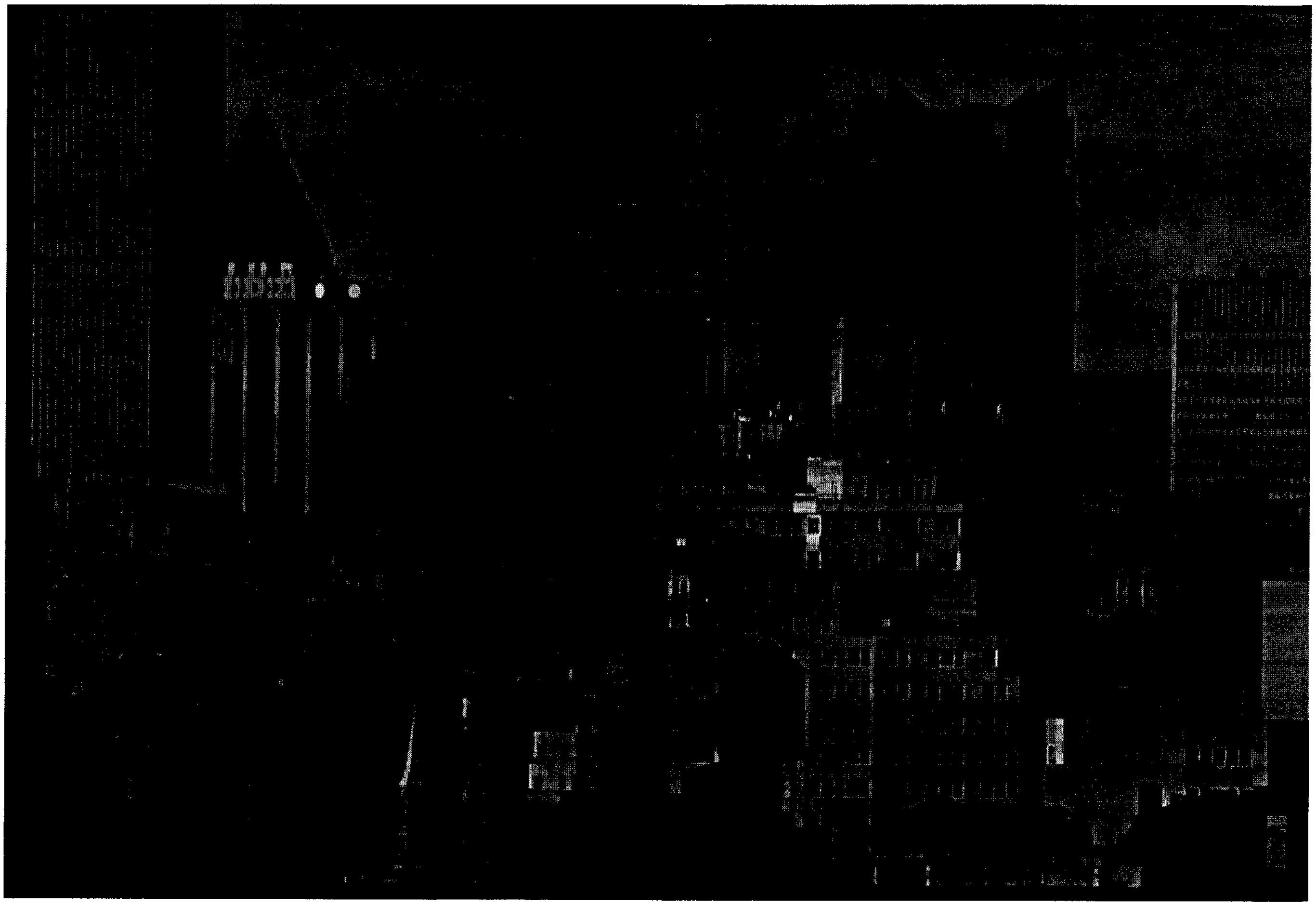
Tax Reform: An Introduction to the Options and Their Effects on Real Estate



Washington, DC
January 2005

Tax Reform: An Introduction to the Options and Their Effects on Real Estate

Deloitte Tax LLP
Washington, DC
January 2005

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EXECUTIVE SUMMARY

One of President Bush's stated second-term priorities is to overhaul the Federal tax code. While the President believes that our tax system is too complex, unfair, and discourages savings and investment, he has not offered a specific reform proposal. Instead, he has appointed a bipartisan advisory panel to study reform options and make recommendations by July 31, 2005.

Tax reform proposals come in two basic forms: (1) fundamental tax reform, which would replace the existing income tax system with an entirely different tax code; and (2) incremental tax reform, which would reform the existing system. The fundamental reform options include a flat consumption (or consumed income) tax, a value-added tax (VAT), and a national sales tax.

> *Tax reform will create "winners" and "losers," and the real estate industry must be prepared for the debate.*

Each reform option would create "winners" and "losers," and the real estate industry must be prepared for the debate. Without reaching conclusions as to the relative merits of one system over another, this paper identifies the options on the table, catalogues the principal arguments for and against those options, and discusses possible impacts each might have on real estate.

Consumption Tax

- **Proposal:** Imposes a single (or flat) tax rate (estimated at 20 percent to 25 percent) on consumption at two levels — on individuals and on all businesses. In the simplest terms, the base amount of taxable consumption is income minus savings and business investment. Business expenditures for real estate are immediately deductible.

- **For:** Generally regarded as simpler than the existing U.S. income tax. Expensing of capital costs could promote long-term growth.

- **Against:** Could shift a greater tax burden to the middle class and would eliminate popular deductions and credits. A consumption tax could also dampen demand and hamper short-term economic growth. With basis eliminated, all asset sales are taxable.

- **Effect on Real Estate Industry:** The cost of commercial real estate would be immediately deductible and all sales fully taxable. Transition issues could negatively affect pricing and behavior in the real estate markets immediately before and after adoption of a consumed income tax.

Value-Added Tax (VAT)

- **Proposal:** Replaces the current system with three components: a simplified income tax on high-income individuals (25 percent), a revised corporate income tax (25 percent), and a new consumption tax, VAT (15 percent), imposed at all levels of production.

- **For:** In theory, a VAT promotes simplicity and capital formation.

- **Against:** Retains much complexity for high-income taxpayers. Shifts the tax burden by eliminating popular deductions and credits.

- **Effect on Real Estate:** A VAT could create a disincentive for new construction because it applies only to newly produced property, thereby increasing the demand for, and value of, existing properties.

National Retail Sales Tax

- **Proposal:** Imposes a single (or flat) rate of tax (estimated at 23 percent to 56 percent) on the retail sale of goods and services by all persons and governments. Primarily administered and collected by the states. Because a retail sales tax is regressive, families would receive a consumption allowance, typically set to subsidize household expenditures up to the poverty line.

- **For:** Promotes simplicity and capital formation.

- **Against:** Significant potential for tax evasion. Invades the state tax base and imposes federal standardization of state taxes. Eliminates popular deductions and credits that promote social programs.

Commercial rentals would effectively be exempt from the sales tax.

- **Effect on Real Estate Industry:** Positive effect on the commercial real estate rental market because commercial rentals would be exempt from the sales tax. Significant transition issues for the residential housing market, because the tax would apply to sales of new homes and to first-time re-sales of existing homes. Possible shift in emphasis at the state level from sales tax to property tax revenues.

Reformed Income Tax

- **Proposal:** Simplifies the current system by eliminating many "targeted" deductions, reducing marginal tax rates, and eliminating the individual AMT. Encourages savings by providing new savings account incentives. Encourages business productivity and capital investment by conforming corporate taxable income to book income and allowing an immediate deduction for a portion of the cost of business plant, equipment, and structures.

- **For:** A reformed income tax could be simpler and retain progressivity, and it could promote capital formation and maintain many popular deductions and credits.

- **Against:** More modest simplification and economic benefits when compared to the fundamental reform options. Future Congresses could easily "un-reform" the system as has happened since the 1986 tax reform.

In all tax reform options, a critical issue for real estate is the transition from the current tax system to the new system.

- **Effect on Real Estate:** The effective tax rate on investments in land would be higher than that imposed on investments in business plant, equipment, and structures because of the allowance of partial expensing for the cost of improvements.

I. Introduction

I. Introduction

A. The President's Tax Reform Agenda

As President Bush begins his second term, one of his stated priorities is to overhaul the Federal tax code. On numerous occasions, the President has expressed his belief that our tax system is too complex, unfair, and discourages savings and investment. While he campaigned on the theme of tax reform, he did not outline specifics — instead, promising to appoint a bipartisan commission to study the overhaul options and make recommendations.

President Bush made good on that promise on January 7, creating an advisory panel, naming its appointees, and directing the panel to submit a report with policy options no later than July 31, 2005. In his executive order, President Bush stated that the purposes of the panel are to (1) simplify federal tax laws, thereby reducing compliance and administrative costs, (2) fairly distribute the federal tax burden while continuing to recognize the social goals of home ownership and charity, and (3) strengthen U.S. competitiveness in the global marketplace by promoting economic growth, job creation, savings and investment. He expressly directed the panel to consider reforming the current income tax system as one of the options for reform.

> *President Bush campaigned on tax reform, but the obstacles to reform are daunting, given the high political and economic stakes.*

The one condition for tax reform that President Bush insists upon is that any recommendation must be revenue neutral.[1] The President supports a tax system that favors investment and savings, as evidenced by his proposals to create and broaden retirement and other tax deferred savings accounts.

The obstacles to meaningful tax reform are daunting, given the high political and economic stakes accompanying such a major policy initiative. This paper will present a brief overview of the major obstacles, which will depend on the nature of the tax reform proposal the

[1] By revenue neutral, the President means not increasing the deficit and apparently uses, as his baseline for neutrality, a revenue figure that assumes all of his previously enacted tax cuts will be made permanent.

President ultimately chooses and the timing of his effort. It is worth noting, however, that while the President is formulating a tax reform agenda, he will also be seeking major Social Security reform, cut the budget deficit in half (which is likely to be about $400 billion), making permanent the tax cuts enacted in 2001 and 2003, and continuing to fight the war in Iraq, at a cost of $4 billion a month.

B. Why the Real Estate Industry Should Focus on Tax Reform

Realizing that the prospects for fundamental tax reform are uncertain, why should the real estate industry focus on this agenda item? There are many reasons, including:

President Bush and many Members of Congress are serious about fundamental tax reform.

The current tax code contains numerous provisions that shape and influence the ways in which real estate is owned, invested in, capitalized, financed, sold or otherwise disposed of and by whom. Changing some or all of these provisions will create change in the industry.

Even initial actions on tax reform — such as a detailed proposal by the president — will have immediate market impacts as investors hedge their positions for new possibilities.

Transitioning to a new tax system will create extraordinary complexity and potential valuation distortions.

Transitioning to a new tax system will create extraordinary complexity and potential valuation distortions between property acquired or placed in service under the current system and property acquired or placed in service under any new system.

C. Tax Reform Proposals — Overview

Tax reform proposals are of two basic types: (1) fundamental tax reform, which seeks to change from our current tax system to an entirely different system; and (2) incremental tax reform, which seeks to reform the existing income tax system. Some of the options for fundamental tax reform are identified in a Treasury Memorandum to former Secretary Paul O'Neill, dated November 7, 2002. Those options include a flat consumption (or consumed income) tax and a value-added tax (VAT). The Treasury Memorandum also identified reform of the current income tax system. Another fundamental tax reform option that has been proposed in Congress is a national sales tax.

> *Fundamental reform would change the current income tax system to a new consumption-based system. Incremental reform would modify our income tax system.*

All these options must be taken seriously and their impact on the real estate industry analyzed. Each of these options would create "winners" and "losers," and the industry must be prepared for the reform debate that will take shape as early as 2005. Without reaching conclusions as to the relative merits of one system over another, this paper identifies the options, with the main arguments commonly advanced for and against each, and discusses some of the possible impacts each tax system might have on real estate.

The current tax system imposes a tax on the net income of corporations and individuals. This is basically the amount earned reduced by specified deductions and credits. The system also contains numerous consumption tax-like provisions that reduce, or eliminate tax on investment income. These include, for example, qualified retirement and health savings accounts, life insurance benefits, the exclusion of gain on personal residences, section 179 expensing, and the reduced tax rate on capital gains and dividends.

The reform proposals, in their most dramatic forms, would redefine the tax base, imposing a tax on what is consumed rather than what is earned. An idealized consumption tax system looks to what the taxpayer does with earnings: if the earnings are spent, they are taxed, but if the earnings are saved or invested, no tax is due. For businesses, the most important changes in a pure consumption tax system are that: 1) capital costs are immediately deductible; and, 2) wages and interest are not deductible.[2] Thus, business investment is tax-free savings, while wages and interest payments are taxable consumption. For individuals, only wages and income that are spent would be taxed. All savings and investment would be tax free.

Replacing a progressive income tax with a single-rate (or flat) consumption tax would raise fairness issues because lower-income taxpayers, who currently bear a low income tax burden, consume a higher percentage of their income on day-to-day living expenses relative to higher-income taxpayers. To adjust for this shift in burden to lower-income households, most tax reform proposals would mitigate the regressive effects either by setting a higher exemption threshold below which consumed income would not be taxed or by providing tax rebates.

Reform proposals would tax what is consumed rather than what is earned. Capital costs would be deductible, wages and interest would not.

A feature common to all of the proposals is the desire to reduce the complexity of the current income tax system. According to some estimates, the annual costs of administering and complying with the current system in 1995 amounted to as much as $75 billion.

D. Effect on Real Estate

The real estate industry must consider the possible impact that tax system restructuring will have on:

- How investors view real estate as an investment,
- Financing choices,
- Property valuations,
- Cost recovery methods,

Tax restructuring could impact investment choices, property values, and borrowing costs.

[2] Unlike the pure form of the consumed income tax, however, the version being considered by policymakers allows a business deduction for wages which are then taxable to the wage earner.

- Holding periods and gain and loss calculations,
- Tax benefits and liabilities carrying over from the current system,
- Tax collection obligations,
- Capitalization choices and borrowing costs, and
- Advantages or disadvantages of owning versus leasing real estate.

Apart from the new tax reform proposal that may be selected, an equally serious near-term issue is the affect of transition from the current system to a new one. Any transition effort should minimize, to the greatest extent possible, the severity of market dislocation for fixed, long-lived assets such as real estate. Certainly, no industry understands this concept more than real estate, given the devastating short-term impact the Tax Reform Act of 1986 had on the industry due to the retroactive application of the passive loss limitation rules.

Any transition effort should minimize the severity of market dislocation for long-lived assets such as real estate.

E. Major Variables in the Tax Reform Debate

Although this paper generally does not address the political viability of reform options, it is nonetheless useful to contemplate the major issues that will frame the political discussion in Washington. A number of these issues are of direct interest to the real estate industry.

Scope and Size of Tax Reform — Policymakers will have to decide the mix of taxes they want to reform. Do they want to scrap the entire tax code, including individual income taxes, corporate income taxes, payroll taxes, the estate tax, and excise taxes? Do they want more limited reform that would replace one or just a few of those taxes? Do they want to simplify the current income tax system while retaining the other taxes? Lawmakers also may consider combining tax reform with Social Security reform. If lawmakers tackle Social Security reform before tax reform, as they plan to do, they may not have enough political will remaining to undertake the latter. Policymakers will have to consider how much change and uncertainty the nation's political and economic systems can absorb.

Distributional Equity — Tax reform proponents often argue that their proposals of choice will be fairer than the current system. Although most analysts who describe "fairness" rely on the notion of "ability to pay" or the taxpayer's capacity to bear taxes, they do not agree on how to assess a taxpayer's ability to pay. Some argue that ability to pay should be based on income. Others say that consumption or wealth should be determinative factors. And still more would argue that any system should be progressive. Ultimately, concerns over fairness may lead to a system that is not as simple as the one that would emerge if simplicity were the chief concern.

Economics will Influence the Debate — Because President Bush wants a new tax system to be revenue-neutral, any reform proposal will have to generate as much revenue as the current income tax. Any major tax reform proposal will trigger new debate over the impact of taxes on a wide range of economic variables, including savings, labor supply, and economic growth. Views taken with respect to these issues will determine whether proposals are seen as revenue neutral and resulting in desirable economic outcomes. Like distributional equity, proponents of any particular reform proposal are likely to argue that their proposal will lead to higher economic growth than competing proposals and, consequently, require a lower tax rate to achieve revenue neutrality.

Tensions Between Transition Relief, Low Rates, and the Tax Base — Because the transition to any new tax system is likely to create winners and losers, lawmakers may wish to help affected parties adjust to that system through transition relief. Such relief could be costly and diminish revenue. To achieve a revenue-neutral proposal, policymakers would have to consider higher tax rates or an expanded tax base to offset these costs, or both. Transition relief will be of major interest to owners of existing assets, including real estate.

Compliance Costs — Tax reform proponents often claim that alternative systems will reduce compliance costs. While an alternative system might be easier to understand and cost less to follow, tax evasion would not disappear. A sales tax, for example, could lead to tax avoidance because it might be difficult to ensure that all transactions are taxed. In any system, the non-reporting of transactions will continue to represent a significant enforcement challenge. The higher the tax rate applicable to each transaction, the greater the probability of avoidance. Thus, the federal government will still need to enforce any new system and not assume that the system will be subject to less avoidance.

Lock-in Effect for Large Assets — Tax reform could have the consequence of causing taxpayers to hold large assets for longer than they otherwise would, thereby distorting markets. For example, under some alternative tax systems, a taxpayer holding real estate would have to include in income the proceeds of the asset's sale. The prospect of such a large tax liability could lead a taxpayer to delay sale of an asset. Moreover, such rules could cause a bunching of income in years when property is sold and excessive losses in others when property is purchased. This could cause a significant mismatch between income and deductions.

Tax reform could cause taxpayers to hold large assets longer than they otherwise would, distorting markets.

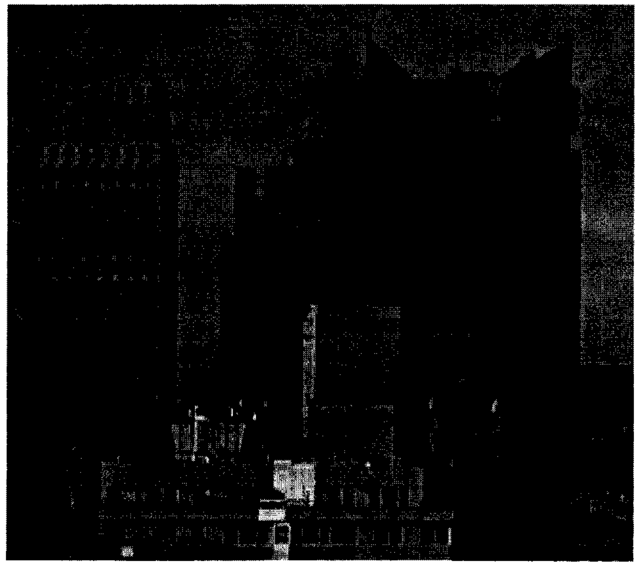
Transfers at Death — To the extent a taxpayer leaves behind untaxed wealth at death, that wealth may be consumed by future generations. Certain tax reform proposals would impose a transfer tax so that wealth could not move between generations and be consumed free of tax. Although there is much debate over the estate tax in the context of the income tax system, some alternative systems also feature such a levy.

Impact on States — State and local governments have at least four concerns with the potential adoption of a federal consumption tax. First, to the degree a consumption tax, such as a VAT or sales tax, creates increased hostility to sales taxes, state and local governments may find themselves either confronted by more angry taxpayers demanding lower taxes or forced to shift tax revenues from sales taxes to property taxes. Second, to the extent any major tax reform has a significant impact on property values, it could be difficult for states to anticipate the effect on state revenues from property taxes. Third, elimination of the federal income tax effectively could require the states to abandon income taxes as part of their revenue base. States would have difficulty enforcing a full-fledged income tax without the comprehensive federal information reporting on which they currently rely. Finally, if all savings and investment income is exempt from federal tax, state and local governments would lose their ability to borrow at advantageous rates through the issuance of tax-exempt bonds.

Treatment of Exempt Entities — Tax-exempt entities, including organizations described in section 501 of the tax code, state and local governments, and entities offering certain tax-preferred savings vehicles (e.g., those for retirement and education savings), would have much to lose from a tax system that generally does not tax saving and investment. These organizations would lose the advantage of being able to provide investors tax-free returns on investments.

Special Industries — An alternative tax system could pose challenges for a number of industries. For example, although a VAT would exempt savings and investment from tax, services would be taxed. Determining how to tax financial intermediaries, such as banks and insurance companies, could be complicated. Lawmakers would have to draw lines between the services these companies provide and investment returns. In addition, certain industries that currently are untaxed or enjoy tax preferences might be subject to tax in an alternative system. A change to the tax system could cause dislocation for, among others, natural resource companies, financial intermediaries, and exempt organizations.

II. Tax Reform Proposals



II. Tax Reform Proposals

The current individual income tax is imposed on gross income from all sources (e.g. wages, interest, dividends, and capital gains) and adjusted by certain deductions, exclusions, and credits. These adjustments are designed to promote social goals, such as home ownership, saving for retirement and education, and charitable giving. The business income tax is imposed on the net amount earned — business profits and earnings from capital — whether capital gains, interest or dividends. How the addition to wealth is spent by individuals or businesses — whether it's consumed, saved, or invested — is ignored in the income tax calculation.

President Bush and many lawmakers view savings and investment as the cornerstone of strong economic growth. They believe the income tax system discourages savings and investment and, therefore, is fundamentally flawed. President Bush believes it is time to consider whether there is an alternative tax system that is fairer and simpler, and that encourages savings, capital formation, and international competitiveness, yet raises the same amount of revenue. To begin this process, President Bush appointed a bipartisan advisory panel to have just this debate and to issue a report by July 31, 2005.

President Bush and many lawmakers believe the income tax system is fundamentally flawed because it discourages savings and investment.

The starting point for the debate likely will be the four basic tax reform options identified above:

1. a consumed income tax,

2. a value-added tax,

3. a national sales tax, and,

4. reform of the current system.

The four options are discussed below. The first three proposals would replace the current income tax with a tax on consumption, each varying on how the "consumption tax base" would be defined.

A. Consumed Income Tax

1. Proposal

This proposal would impose a single tax rate on consumption at two levels — on individuals and on all businesses (both corporate and pass-through entities). The consumed income tax is "flat" in the sense that it imposes tax at only one marginal rate. In the simplest terms, the base amount of taxable consumption is income minus savings and business investment. To be revenue neutral, the 2002 Treasury Memorandum estimated that a tax rate of 20 percent to 25 percent would be required. The consumed income tax would completely replace the current income tax on individuals and corporations and repeal the estate and gift tax. The payroll/Social Security tax system would be retained. The individual and corporate alternative minimum tax would be eliminated.

> *Business income derived from investment would not be taxed, and capital expenditures for items such as real estate would be immediately deductible.*

Business Income. Businesses, regardless of legal form, would be taxed on "gross business income" less (1) purchases from other businesses, including inventory and the cost of capital goods (personal and real property used in the activity), (2) wages and compensation, and (3) contributions to pension accounts (including the employer's portion of social security taxes). No other deductions or business credits would be permitted — meaning that items such as employee benefits and business interest would not be deductible.

As a result, business income derived from investment (as opposed to operations) would not be taxed. From a real estate industry perspective, gross receipts of developers, builders, and dealers would be taxable, as would rental income received by landlords. Capital expenditures to acquire real property utilized in a business would be immediately deductible. Gains from the resale of homes by individuals or from property held purely for investment (not by businesses) would be exempt.

Individual Income. Individuals would be taxed on their compensation for personal services (wages), plus pension distributions, less a standard deduction of about $25,000 for joint returns and $5,000 for each dependent. Individual itemized deductions (including mortgage interest) and most tax credits (except the earned income tax credit) would be eliminated. Interest, dividends, capital gains and other investment income would not be taxed.

2. Arguments Commonly Advanced For and Against a Consumed Income Tax

a. For

- **Capital Formation.** Allowing businesses to deduct capital costs would encourage capital formation and be an incentive for savings and investment.

- **Simplicity.** Increasing simplicity could reduce the costs of compliance and enforcement, help U.S. companies compete in the global marketplace, and remove some moderate-income families from the income tax rolls.

- **Inflationary Effects.** Permitting expenses of investments would eliminate inflation-related distortions in the measurement of investment income.

b. Against

- **Regressivity.** The consumed income tax would shift the tax burden of those in the upper income levels to the middle class.

- **Social Policy.** The consumed income tax would eliminate deductions that currently promote social goals (health care, housing, retirement, and charitable giving).

- **Compliance**. New compliance-related concerns would arise relating to the treatment of interest payments. Interest income would be exempt from tax, creating incentives for business to treat a larger share of receipts as interest income. Similarly, since business interest would not be deductible, businesses would want to have any payments regarded as a purchase.

- **Economic Transition Effects.** The tax would create disincentives to consumption in the near-term and could initially slow the economy.

- **International Competitiveness**. From an international perspective, unlike the VAT, the flat tax would not qualify as an indirect tax for World Tax Organization purposes because of the deduction for wages paid under the business component of the tax. Thus, any rebate of the tax for exports would be regarded as a subsidy violating WTO rules.

3. Effect on Industry

a. Real Estate Assets

Were the U.S. to convert to a consumed income tax, numerous changes within the tax system would impact the value of real estate assets.

Significantly, under a consumed income tax system, the cost of real estate used in connection with a business would become deductible upon purchase. This could provide a significant benefit, assuming that favorable loss carryover provisions are adopted as part of the system. Improvements, which currently are written off over 15, 27.5, or 39 years, would become deductible immediately. The cost of land, which currently is not subject to depreciation, would become immediately deductible as well.

Without adequate carryovers, real estate owners would experience a bunching of income in years when property is sold, while incurring excessive losses in others when property is purchased.

If loss carryover provisions were not adopted, or if the carryover period were limited, immediate deduction of purchase costs could be unfavorable. If a purchaser did not have income in a given year (or period of years if a limited loss carryover were permitted) at least equal to the cost of acquired property and other deductible expenditures, a portion of the deductions attributable to the purchased property would go unused.

As a parallel to the immediate write-off of the purchase price of property, sellers would have to include all gross proceeds from the sale of property as current income. This could lead to a significant tax bill in the year an asset is sold and could cause taxpayers to hold assets for longer than they otherwise would. Unlike other businesses, where purchases and sales may be relatively constant over time, purchases and sales could be more inconsistent in many real estate businesses. This could cause a bunching of income in years when property is sold, while incurring excessive losses in others when property is purchased. Again, as long as acceptable loss carryover provisions are adopted, this effect would be mitigated. Without such carryover provisions, a consumed income tax would create significant problems with the mismatching of income and deductions.

As discussed more fully below, under a consumed income tax, business interest payments on borrowed funds would not be deductible. The lack of a deduction, standing alone, would raise the after-tax cost of holding real estate and could depress the value of such property. Notably, however, interest income also would not be taxable to the investor. The question of what would happen to interest rates is complex. U.S. investors will benefit if interest rates fall, but rates are subject to global market forces and monetary policy. As a result, it is impossible to predict the direction interest rates will move.

The lack of a deduction for interest would raise the after-tax cost of holding real estate and could depress property values.

Other expenses that might no longer be deductible under a consumed income tax include property taxes, state and local income taxes, and employee benefits. Elimination of the property tax deduction would likely have an adverse affect on the real estate industry disproportionate to most other industries.

b. Entities Holding Real Estate

Under the current system, real estate is held through numerous types of entities. From a state law perspective, these entities include corporations, limited liability companies, partnerships (both general and limited), and trusts. From a federal income tax perspective, the entities include C corporations, S corporations, REITs, partnerships, trusts, and title holding companies under section 501(c)(25).

The decision as to the preferable type of entity for holding real estate generally is made based on both business and tax concerns. The federal tax concerns that factor into the decision regarding choice of entity generally relate to whether (1) tax will be imposed at the entity level, (2) income character will pass through to investors, (3) losses will pass through to investors, and (4) business activity of the entity will be attributed to investors (i.e., tax-exempt and foreign parties).

"Federal law" entities such as S corporations, REITs, and title holding companies could become obsolete.

Under a system based on the consumed income tax, the federal tax concerns would virtually disappear from the "choice of entity" decision. Business income would be subject to tax regardless of whether the business earning the income was conducted by an entity formed under state law as a corporation, limited liability company, or partnership. Similarly, investors would be exempt from tax on all investment income. There would be one level of tax collected at the business level, no pass-through of business income or losses, and no attribution of business activities. Accordingly, pass-through entities that are creatures of federal tax law, such as S corporations, REITs, and title holding companies under section 501(c)(25), could become obsolete.

Foreign investors might continue to have concerns regarding the type of entity through which they invest in real estate, depending on the relevance of the entity for the investors' home-country taxation. U.S. taxpayers might continue to care about entity choice in states that do not adopt the consumed income tax.

c. Financing of Real Estate

As mentioned above, under a consumed income tax, all investment income, including interests and dividends, would be exempt from tax. Conversely, no deduction would be permitted to the payor of such amounts, so interest payments on debt would cease to be deductible. As a result, the tax benefits of financing real estate activities through debt would be reduced. At the same time, the question of what would happen to interest rates is complex. U.S. investors will benefit if interest rates fall, but rates are subject to global market forces and monetary policy. As a result, it is impossible to predict the direction interest rates will move. Overall, the cost of equity as compared to debt should become solely a factor of the different risk inherent in the instruments. Differences in pricing due to the tax impact of the various instruments should disappear.

The tax benefits of financing real estate through debt would be reduced.

d. Investors

Taxable Investors — Taxable investors in real estate businesses could benefit from a consumed income tax system, as all investment income would cease to be taxable. Whether these investors advanced money in the form of debt or equity, their returns would cease to be subject to tax. As an offset to this benefit, however, additional tax would be imposed as a result of denying deductions and credits. This treatment would contrast with current investments through entities such as partnerships, REITs, or section 501(c)(25) title holding corporations, where real estate income is not subject to tax other than at the investor level. Although in either case, only one level of tax would be imposed.

Taxable investors in real estate could benefit from tax-free investment income.

Tax-Exempt Investors — It is unclear how tax-exempt investors will be taxed on real estate investments. Where a tax-exempt investor invests with others in a business that holds real estate, it would seem that the business would be subject to the consumed income tax with respect to its operations, just like any other business. Accordingly, the tax-exempt investor, like the taxable investor, would receive its return from the business net of the "business-level" tax. Because both taxable and tax-exempt investors would pay no tax on investment returns, the benefit to being a tax-exempt investor would seem to disappear. In contrast, if a tax-exempt entity were permitted to operate a real estate operation free from tax, it would receive a significant benefit from the consumed income tax.

4. Transition Issues

After-tax wealth accrued under the existing income tax would be taxed again when it is consumed under a consumed income tax, absent transition relief. However, if the consumed income tax were to exempt "old" taxed income as transition relief, the tax rate that would be required on "new" consumed income would be significantly higher.

After-tax wealth accrued under the existing income tax would be tax again when it is consumed, absent transition relief.

Further, under a consumed income tax system, a taxpayer is subject to tax on the gross receipts attributable to the sale of property. Because a taxpayer is permitted to deduct the purchase price of such property, no tax basis would exist to shelter subsequent proceeds from tax.

Without transition relief, if a taxpayer were to purchase property immediately before the effective date of a consumption tax system (at a time when no deduction is permitted for the purchase price), and then sell the property immediately after the effective date for the same amount as the purchase price (at a time when the tax is measured by reference to the gross receipts on the sale), the taxpayer would be subject to tax with respect to the entire sales proceeds, with no offset for the amount paid to purchase the property.

Without transition relief, there could be a significant impact on both pricing and behavior in the real estate market immediately before and after adoption of a consumed income tax. If the market became concerned that such a system would be adopted, adverse impacts would occur as taxpayers, concerned with the loss of current benefits, delayed purchase decisions. By contrast, once the consumed income tax system became effective, the pent up demand would be released, and there would be a significant increase in the price of real estate.

Real estate pricing and marketplace behavior could be significantly affected immediately before and after adoption of a consumed income tax.

In addition to the economic disruptions that could be created, there could be disadvantages, absent transition relief, for taxpayers who purchased real estate before realizing that a consumed income tax was a possibility. The benefit of any remaining tax basis that they had in real estate would effectively be lost upon a conversion to a consumed income tax system. One possible option is to allow some recovery of the income tax basis on existing assets at the time of conversion to the new system.

Although not strictly a transition issue, one matter that would require immediate attention is the treatment of consolidations under any new tax system. Current law contains many impediments to taxpayers merging solely for tax purposes. Although, in theory, a tax code designed to affect all taxpayers similarly would not necessarily contain such restrictions, general public expectations probably require limitations on the transfer of losses and accompanying complexity.

If lawmakers wish to compensate businesses for lost depreciation deductions and carryforwards of credits (including AMT credits) and net operating losses, substantial transition relief would have to be provided. However, that would make achieving revenue neutrality difficult and require a higher tax rate for at least a transitional period.

Further, financial transactions involving the payment of interest would need to be addressed, since many are currently structured based on the tax attributes of the borrower and lender. In this regard, an exception for the mortgage interest deduction would encourage taxpayers to incur home mortgage debt.[3]

The current tax system contains many additional provisions that are designed to meet some social purpose, including credits for research and development, job training, historic preservation, and environmental safety. To the extent these items remain preferred social and legislative objectives, a consumption tax could be modified to accommodate such provisions, albeit at the expense of introducing some complexity for tax filers and for those administering the tax compliance process.

B. Add-On Value-Added Tax (VAT)

1. Proposal

Under this proposal, the current system would be replaced with three components:

1. a simplified income tax on high-income individuals,
2. a revised and simplified corporate income tax, and
3. a new consumption tax.

The income tax would be simplified for individuals, with a low flat rate and designed so that 90 percent of individuals would not pay income tax. The corporate income tax would be integrated with the individual income tax by eliminating the double tax on corporate earnings. To pay for the lost revenue, a new consumption-based value-added tax (VAT) would be implemented. There would be no individual or corporate alternative minimum tax, but the payroll tax would remain in force.

The double tax on corporate earnings would be eliminated.

[3] This taxpayer behavior would be consistent with research findings following enactment of the Tax Reform Act of 1986 ("TRA 1986"). In the years subsequent to TRA 1986, the evidence indicates that although total borrowing by individuals remained relatively unchanged, households shuffled consumer debt into mortgage debt. The net effect of such movement was that federal tax revenue was only half as much as had been projected based on 1986 consumer debt levels.

Business Income Tax. Corporate taxpayers would pay a single rate of 25 percent on book income as determined for financial accounting purposes. The elimination of a separate tax accounting system would simplify the tax rules for corporations and could reduce the appeal of corporate tax shelters to publicly traded entities — because any reduction in taxable income would also reflect a reduction in book earnings. The tax rate and depreciation schedules for individuals and corporations would be identical, so that small corporations could pass through their earnings to shareholders. The double tax on corporate earnings would be eliminated by either making dividends deductible or giving shareholders a credit for corporate taxes paid.

Business VAT. A new federal consumption tax (VAT) of 15 percent would be applied to virtually all goods and services. Sales for export would be zero-rated.[4] Expenditures on medical care, education, and religion would be zero-rated. Tax would also be imposed on the sale of new buildings and rental income, but the resale of existing homes would be exempt. The VAT would be paid by corporate and noncorporate businesses using a credit-invoice method at all levels of production. Business sellers would pay the VAT on all gross receipts, with a credit given for the taxes paid on items purchased from other businesses. The VAT would be imposed only on the increase in value added by the business. Thus, taxes would be collected throughout the year at all levels of production, not just at the point of final retail sale.

A VAT would be imposed on the sale of new housing and rental income.

Individual Income Tax. Individuals would pay a single rate of 25 percent on all income — whether from wages, pension distributions, business pass-through income, capital gains, interest, or dividends. A "family allowance" of $100,000 per joint return ($50,000 for unmarried taxpayers) would replace the standard deduction, and individuals would deduct the greater of that amount or itemized deductions consisting of mortgage interest, charitable contributions, medical expenses and state/local taxes. All tax credits would be repealed.

[4] A zero rate effectively exempts these sales while allowing a credit for the VAT paid on purchased goods and services.

2. Arguments Commonly Advanced For and Against an Add-On VAT

a. For

- **Simplicity.** There would be a dramatic increase in simplicity for any individuals or small businesses who no longer file income tax returns. With a single rate and a redefined tax base, the tax filing for higher income individuals and businesses would be greatly simplified.

- **Progressivity.** A form of a progressive tax structure would be retained.

- **Investment and Savings.** Individuals with income under $100,000 would not be taxed on savings and investment, thus providing incentives for capital formation.

- **Less Abuse.** Conforming the corporate tax base to book income, and integrating the corporate and individual income taxes would reduce incentives for corporate tax shelters.

b. Against

- **Financial Statements.** Tax reliance on financial statements is inappropriate for several reasons. First, integrity of financial statements is a major public policy priority. Bringing tax considerations directly into the discussion of financial statement rules and preparation would not be helpful. Second, many business entities do not prepare GAAP statements, and even fewer file statements with the SEC. The tax writing committees and IRS would have to provide rules defining income for these entities. Third, uncertainty would occur if the IRS started taking positions on financial accounting rules that appeared to differ from the interpretations of accounting regulatory bodies. Finally, it is unclear how financial statement restatements would be treated for tax purposes.

- **Adjusting for Equity.** To assure fairness to lower income taxpayers, preventing them from bearing an increased share of the tax burden, this system would require a further withholding tax adjustment and other credits.

- **Fewer Incentives for Social Goals and Capital Formation.** With fewer individuals itemizing, the tax incentives for charitable giving, purchasing owner-occupied housing, and investing in state and local government would be reduced. Since most capital is held by high-income taxpayers and capital income would continue to be subject to a 25 percent tax, there would be no explicit tax incentives for capital formation at this level.

- **Administrative Complexity.** Businesses would have to file income tax returns and VAT returns and collect and remit the VAT. Businesses would still have to file payroll tax returns. The VAT would impose substantial new record-keeping requirements.

- **State Conformity.** State tax systems would have to conform to the federal system, otherwise the tax filing simplicity would be compromised.

3. Effect on Industry

a. Real Estate Assets

In determining the affect of an Add-On VAT system for real estate assets, one must initially separate the VAT component and income tax component and consider the impact of each component in isolation.

With respect to the VAT, the Treasury Memorandum indicates that sales of new housing and rental income would be subject to the VAT, but re-sales of existing homes would not. Although not entirely clear, we assume that similar treatment would apply with respect to commercial properties.

Because of the credit mechanism, lessors of newly-constructed property could pass on the VAT incurred in acquiring the property to the lessee.

Note that there is no indication of how situations would be handled where used housing is significantly remodeled in preparation for sale. Presumably, out-of-pocket costs for materials and services in the remodeling would be subject to sales tax; however, increases in value attributable to "sweat equity" might well escape taxation.

Subjecting rental income to the VAT, both with respect to newly-constructed and existing properties, raises additional issues. Because of the credit mechanism, lessors of newly-constructed property could pass on the VAT incurred in acquiring the property to the lessee. Lessors of existing and new property would collect the same amount of tax on the rental from the lessees, but only the lessor of new property would have paid the VAT on the acquisition. A lessor who purchases property subject to the VAT would have VAT credits in the year of transition far in excess of VAT liabilities associated with the collection of rent from that property. This would require refundability of excess VAT credits or adoption of carryover rules and could create an additional incentive for small investors to invest through entities owning multiple properties.

Imposition of the VAT with respect to rental payments could create an incremental incentive for owner-occupied properties. That change in incentive, however, could be offset by declines in the value of mortgage interest deductions for both taxpayers newly exempt from the income tax and taxpayers experiencing dramatically reduced marginal tax rates.

With respect to the income tax component of the Add-On VAT system, the impact on real estate would seem to be slight. Lower tax rates at the corporate and individual level would be favorable, but such rates would apply with respect to all investments, so real estate would not be favored. Similarly, the addition of the VAT would likely offset any benefits bestowed as a result of lower income tax rates. Full integration of the corporate and individual taxes could increase the incentive for real estate ownership by corporations, which could produce some marginal benefit for real estate.

A VAT would eliminate like-kind exchange deferral.

One aspect of the proposal that is somewhat ambiguous relates to the extent to which taxable income would be conformed to income as determined for financial reporting purposes. Buildings and improvements typically have significantly longer depreciable lives under GAAP than under the current tax rules. Accordingly, if depreciation were conformed, this could be harmful to real estate. Of potentially even greater importance, GAAP does not recognize the concept of like-kind exchanges.

Elimination of gain deferral for like-kind exchanges would have a significant impact on the real estate industry to the extent capital gain income remains taxable.

b. Entities Holding Real Estate

Entity choice would have no relevance under a pure VAT system. As with the consumed income tax, the VAT is collected at the "business" level, regardless of what form of entity is conducting the business.

Unlike a pure VAT system, however, with an Add-On VAT, an income tax component would remain in the system. Although the large standard deduction would make the income tax irrelevant for many individuals, and full corporate integration would reduce the difference between entities taxed as corporations and entities that provide varying levels of pass-through treatment, federal income tax concerns still would play a role, albeit somewhat diminished, in determining the choice of entity.

REITs could be less attractive under a VAT.

To the extent an investor had the capacity to utilize losses, that investor would continue to prefer investing in an entity that will be taxed as a partnership (or possibly an S corporation). Given the operational limitations imposed on REITs, full corporate integration through the exclusion of dividend income would make the single level of tax afforded by REITs less attractive.

Nonetheless, for tax-exempt investors that may have concerns with unrelated business taxable income generated by a pass-through entity like a partnership, there may be a continuing benefit to investing through an entity like a REIT where the tax is eliminated at the entity level (as opposed to the shareholder level).

Non-U.S. taxpayers may see similar benefits to investing in real estate through a REIT. It should be noted that, if Congress became aware that REITs were being used exclusively (or almost exclusively) by tax-exempt and non-U.S. taxpayers, it is unclear that the REIT regime would be retained.

c. Financing of Real Estate

With respect to the VAT, the Treasury Memorandum states that "[t]he taxation of financial services traditionally is seen as a problem for consumption taxes since measuring the value of these services is difficult. This issue would need to be addressed under the VAT." Because no specific proposal has been made with respect to the application of the VAT in the financial services industry, it is difficult to project how the VAT would impact financing alternatives. Nonetheless, in no event would income that represents a return from capital be subject to the VAT. Thus, the VAT would not create a preference from a federal tax perspective as between equity and debt financing.

The distinction between debt and equity under the income tax portion of this system would be less significant than under the current system. As under the current system, interest would continue to be deductible to the payor and generally would be includible in the income of the payee. Under the new system, either dividends would be deductible to the payor corporation or the shareholder would be given a credit for the taxes paid by the corporation.

Interest would continue to be deductible to the payor and includable in the payee's income.

For entities other than corporations, the federal tax system seemingly would continue to create a preference for financing acquisitions and operations through debt. For corporations, however, the decision is not quite as clear. A single layer of income tax can be obtained either through the payment of interest or dividends, although in one scenario (i.e., interest), the layer of tax is eliminated at the corporate level, while in the other scenario (i.e., dividends), the question of how the double tax would be diminished remains unanswered. Differences in the level at which the tax is eliminated can create different incentives for management.

d. Investors

Taxable Investors — Taxable investors would not be subject to the VAT with respect to dividend, interest, and capital gain income. Such investors generally would also avoid income tax with respect to such income. These seemingly favorable results in the corporate context, however, could be largely offset by the added tax burden at the entity level created by the VAT.

Taxable investors in pass-through entities like partnerships and LLCs, or other entities like REITs that provide for a single level of tax, similarly would not be subject to the VAT with respect to distributions or income allocated to such investors. These investors, however, would continue to be subject to income tax with respect to equity returns from these entities to the extent that the increased standard deduction for individuals did not eliminate such liability.

Tax-Exempt Investors — It is unclear whether some or all tax-exempt organizations would be exempt from the VAT generally. The Treasury Memorandum indicates that expenditures on medical care, education, and religion would be exempt. This carve-out of certain expenditures may give some indication that entities promoting specific goals could be exempt from the VAT.

From the perspective of an equity investor in real estate, the exclusion for tax-exempt investors does not appear to be significant, as it does not appear that equity returns would be subject to the VAT in any event.

From an income-tax perspective, the exclusion of dividend income would be of no value to tax-exempt investors. These investors would prefer that the tax be eliminated at the corporate level so as to maximize distributable cash to the tax-exempt investors. Given that these investors will not be subject to tax on either dividends or interest, they probably would prefer to receive their distributions as interest to the extent their desired return can be achieved through an investment as a creditor.

4. Transition Issues

As with the consumed income tax, the transition issues in a system that relies in part on the VAT would be formidable. Under the model proposal set forth in the Treasury Memorandum, a VAT could be imposed on existing wealth at the time of the adoption of the VAT. The impact of this one-time tax and the potential economic dislocations would be enormous. This could create hardship for those holding illiquid assets and require the adoption of transition rules or delay in the imposition of the tax until the asset is sold. If such a tax

The VAT could be imposed on existing wealth, which could create hardship for parties holding illiquid assets.

were not imposed at the time of the adoption of the VAT, however, significant disparities could be created between certain sets of taxpayers. This could be particularly true in the real estate industry.

Without the "toll charge" upon adoption of the VAT, legislation could cause market disruptions as the timing of construction activity is managed to minimize tax burdens before and after adoption. Given the more favorable treatment of used property as opposed to newly-constructed property, those who own completed property at the time the VAT is adopted could see a rise in the value of their property. This increase in value would be attributable to the fact that a person trying to re-create such a property through new construction would have the added cost of the VAT to contend with.

C. National Retail Sales Tax

1. Proposal

This proposal would create a national sales tax, primarily administered and collected by the states. It would impose a single (or flat) rate of tax on the retail sale of goods and services by all persons and governments, presumably including sales over the Internet. (Purchases for resale, production and export would not be taxed, and some limited items, such as payments for education, would be exempt.) Wages would no longer be subject to tax. A tax on consumption would be imposed directly on the consumer. Business to business purchases would be exempt from tax. Interest, dividends, capital gains and other investment income also would not be taxed.

> *The projected tax rates would range from 23% to 56%.*

Because a retail sales tax is regressive, each family would receive a consumption allowance, typically set to subsidize household expenditures up to the poverty line. Depending on how the tax is calculated and collected, the projected tax rates would range from 23 percent to 56 percent.

2. Arguments Commonly Advanced For and Against a National Retail Sales Tax

a. For

- **Simplicity**. Dramatic increase in simplicity would reduce the costs of compliance and enforcement.

- **Capital Formation.** Eliminating the income tax on savings and investment would encourage capital formation and economic growth.

- **Manipulation Eliminated**. The tax code could no longer be used by Congress to create "winners" and "losers."

- **Reduced Federal Presence**. Substantial parts of the Internal Revenue Service would be abolished.

b. Against

- **Regressivity**. The national sales tax would shift the tax burden of those in the upper income levels (who save) to those in the lower and middles classes who consume all their income.

- **Citizen Tax Collectors**. The retail sector would bear the entire burden of collection at time of retail sale.

- **Evasion**. The potential for tax evasion likely would be high, because of the very high combined federal, state, and local tax burden and because the retail sector is comprised predominantly of small businesses that would be virtually impossible to audit to assure compliance.

- **Elimination of Social Programs**. This system would eliminate income tax deductions that currently promote social goals (health care, housing and charitable giving).

- **Burden on State and Local Governments**. States could be faced with an unfunded mandate, requiring them to bear significant administrative costs of collecting federal sales taxes. Further, a federal sales tax would invade a tax base historically reserved to state and local governments. Elimination of the federal income tax also could require states to abandon income taxes as part of their revenue base, because states rely on federal tax information collection to enforce their income taxes.

3. Effect on Real Estate Industry

a. Real Estate Assets

Under the national sales tax that has been proposed in Congress (the Fair Tax Act), any property or services sold to a non-business consumer that had not previously been subject to sales tax would be subject to sales tax based upon the gross sales proceeds. This one-time cost seemingly would increase the cost of property to the end purchaser or user.

In the case of housing, once a home had been sold and subjected to sales tax, no future sale of the home would be subject to the sales tax. The fact that used homes would not again be subject to the national sales tax could create downward pricing pressures with respect to new homes competing for buyers against existing housing. Conversely, a seller of an existing home would be mindful of the home's original cost (including any sales tax) in setting the asking price for the home. Accordingly, the actual differentiation with respect to used homes and newly-constructed homes is difficult to determine. Note that there is no indication of how situations would be handled where used housing is significantly remodeled in preparation for sale. Presumably, out-of-pocket costs for materials and services in the remodeling would be subject to sales tax; however, increases in value attributable to "sweat equity" might well escape taxation.

Proceeds from the business rental of property would be excluded, but the value of retail goods and services attributable to the occupancy of rented business space would be taxed.

Proceeds from the business rental of property would be excluded from the national sales tax. But, of course, the value of retail goods and services attributable to the occupancy of rented business space would be taxed. A sales tax would only adversely affect the residential real estate market (i.e., rental at the "retail" level).

Because the national sales tax would not be an "income" based tax, the distinction between debt and equity from the borrower or issuer's perspective would become meaningless, as there would be no deduction provided for either interest or dividends.

Elimination of any appreciable federal tax on business activity, coupled with a significant tax on consumer purchases, likely would create downward pricing pressure with respect to the before-tax pricing of goods and services.

b. Entities Holding Real Estate

As with a pure VAT, under a national sales tax, federal tax concerns would become largely irrelevant in determining what sort of entity would be best to hold real estate. The sales tax would be collected at the business level regardless of the type of entity collecting the tax, and investors would not be subject to tax on investment income derived through ownership of any entity.

Consistent with the situation under the consumed income tax, non-U.S. investors may continue to prefer certain entities, depending on the tax regime in their home countries.

c. Financing of Real Estate

The Fair Tax Act would impose a sales tax on financial intermediation services. Interest would be excluded from the definition of financial intermediation services. However, special rules would limit the amount of payments in connection with a loan that are treated as "interest" to prevent disguising fees for taxable services (like loan origination and processing fees) as tax-exempt interest.

For financial intermediation services provided in connection with a borrower's trade or business or investment activities, no sales tax would be imposed. Accordingly, financial intermediary services utilized in connection with the purchase of a home would be subject to the sales tax, while such services utilized in connection with other real estate activities would seem to be exempt.

d. Investors

Taxable Investors — The return of a taxable investor in a real estate business, whether attributable to periodic returns (i.e., dividends, partnership distributions, etc.) or upon the sale of the investment, would not be subject to the national sales tax.

Tax-Exempt Investors — Tax-exempt investors would not be subject to tax with respect to investment returns. Concepts like unrelated business taxable income, which subject tax-exempt entities to income tax with respect to their business activities that are unrelated to their exempt purpose, would become irrelevant.

Concepts like unrelated business taxable income would become irrelevant.

4. Transition Issues

The national sales tax would not tax either property previously taxed or property held other than for business purposes on the date of transition. As a result, the tax would apply to retail sales of existing property held by a trade or business on the transition date. But, for inventory disposed of within two years following adoption of the national sales tax, this sales tax would be mitigated by an inventory credit equal to the sales tax that would have been imposed with respect to the cost of the property.

In the case of real estate, this would mean that sales of existing homes out of a builder or developer's inventory would be subject to the sales tax. The builder or developer would, however, be entitled to a credit equal to its costs incurred before the transition date times the tax rate.

D. Reformed Income Tax

1. Proposal

This proposal could eliminate many "targeted" deductions, reduce marginal tax rates, eliminate the individual AMT, provide new savings account incentives, conform corporate taxable income to more closely resemble book income for financial accounting purposes, and allow partial expensing of the cost of business plant, equipment, and structures. The remaining cost would be recovered under book income rules.

Business Income Tax. Corporate taxpayers would pay a lower (to be determined) rate of tax on book income as determined for financial accounting purposes. Special business tax credits, deductions, and rates would be repealed. A portion of capital expenditures for business plant, equipment, and structures would be immediately deductible. Conforming changes would be made for pass-through entities.

> *A portion of capital expenditures by businesses would be immediately deductible.*

Individual Income Tax. Individuals would pay a progressive tax under four rates ranging from 10 percent to 35 percent. To remove lower income families from the tax roles, the standard deduction would be significantly increased. The itemized deduction for state and local taxes would be repealed, and other deductions/credits would be simplified. The separate rate system for capital gains would remain. The current menu of retirement, education, and medical savings accounts would be replaced by two new savings programs — the Lifetime Savings Account and Retirement Savings Account. Contributions of up to $5,000 per account per year would not be deductible, but earnings would accumulate tax-free, and distributions (after age 57 for the RSA) would not be taxable. The individual AMT would be repealed.

2. Arguments Commonly Advanced For and Against a Reformed Income Tax

a. For

- **Simplicity.** Returns for most individuals would be simple. A return-free system covering 70 percent of individuals would be possible. Nevertheless, the degree of simplicity offered by other proposals would not be achieved, and some taxpayers may have tax increases

- **Progressivity**. A progressive tax structure would be retained.

- **Savings and Capital Formation**. Allowing businesses to deduct some amount of capital expenditures would encourage capital formation. The savings incentives and lower rates for capital gains would encourage savings and investment.

- **Reduced Abuse**. Incentives for corporate tax shelters would be reduced with book income as the tax base.

- **Social Policies.** Incentives supporting selected social policies (such as charitable giving and home ownership) would be retained.

b. Against

- **Financial Statements.** Tax reliance on financial statements is inappropriate for several reasons. First, integrity of financial statements is a major public policy priority. Bringing tax considerations directly into the discussion of financial statement rules and preparation would not be helpful. Second, many business entities do not prepare GAAP statements, and even fewer file statements with the SEC. The tax writing committees and IRS would have to provide rules defining income for these entities. Third, uncertainty would occur if the IRS started taking positions on financial accounting rules that appeared to differ from the interpretations of accounting regulatory bodies. Finally, it is unclear how financial statement restatements would be treated for tax purposes.

- **Advantage for Non-Realty Investments**. Partial expensing of investments in business plant, equipment, and structures would lower the effective tax rate on these assets as compared with inventories and land.

- **Political Challenge**. Flattening of the tax rates in a revenue-neutral reform bill will require the elimination of many deductions and credits.

The partial expensing of the cost of business plant, equipment, and structures could be advantageous for improved real property.

- **Future "Unreform."** Future Congresses could easily unreform the tax code and reintroduce complexity and higher rates.

3. Effect on Real Estate Industry

a. Real Estate Assets

It is tempting to conclude that the reformed income tax proposal would have the least impact on real estate and the overall economy in general, since it represents the least significant departure from the current system of taxation. However, the current tax code creates important relative advantages for real estate. Loss of some or all of these relative advantages could cause a shift of investment from real estate to other assets.

The allowance for partial expensing of a portion of the cost of business plant, equipment, and structures should be advantageous for improved real estate. Noncorporate taxpayers presumably also would continue to be able to take advantage of deferral provisions such as installment sales and like-kind exchange treatment, which would continue to provide important tax benefits if capital gains taxation were retained.

Conversely, because raw land, investment property, and property held as inventory would not share in this benefit, the relative after-tax returns with respect to such properties could be reduced vis-à-vis the described business property.

With respect to individuals, any repeal of the deduction for state and local taxes, particularly real property taxes, would be disproportionately harmful to real estate, although the magnitude of the harm is difficult to determine.

b. Entities Holding Real Estate

Under the reformed system that has been described, the "choice of entity" issues would be as they are today. There is no indication that corporate integration would be advanced under this proposal, so the distinctions between C corporations and entities that provide for a single level of tax (like partnerships, REITs, etc.) would remain. The expanded investment accounts would exempt from tax a portion of an individual's investment income, but a significant portion of investment income would remain subject to tax. Accordingly, some investors would continue to differentiate between entities based on the character (i.e., capital gains or

Entities like partnerships and REITs would remain.

ordinary income) and timing (i.e., upon receipt of distributions from the entity or allocations as income is earned by the entity) of income inclusions attributable to investments in the entity. In addition, because individuals and corporations will remain subject to tax based on a concept of "net income," the ability to pass through losses would continue to be relevant.

c. Financing of Real Estate

A change to the reformed income tax system as described above likely would not have a significant impact on financing alternatives in the context of real estate investment. If savings is increased as a result of the modified savings accounts for individuals, this could have the effect of reducing interest rates. Any such reduction would likely be small, however, because, although the savings of many individuals would no longer be subject to tax, the aggregate size of individual savings accounts likely would also continue to be small.

d. Investors

Taxable Investors — It would appear that the reformed income tax system would not significantly alter the treatment of taxable investors in real estate. The different rate structures for ordinary income and capital gains would be maintained. In addition, corporate integration would not appear to be a part of this proposal, so the double layer of tax with respect to C corporation investments would continue under the reformed system.

Tax-Exempt Investors — The repercussions of the reformed income tax system on tax-exempt investors with respect to real estate would not seem to be significant. The proposal indicates no significant changes in the context of such investors.

4. Transition Issues

While transition issues will exist in the context of the reformed income tax, they would not appear to be as significant as in the other proposed system. The most significant change would be the deduction by businesses of a portion of the costs of plant, equipment, and structures. Note, however, that such benefits could be offset by the use of longer GAAP depreciation lives with respect to the portion of property that is not expensed. Depending on the relative benefits and determinants of the two changes, taxpayers could delay or accelerate their purchase or construction of such items until after adoption of the reformed system in order to take advantage of the increased deduction. The magnitude of the impact on behavior would relate to what portion of such expenditures could be permitted as a deduction.

E. Potential "Deadwood" Under New Tax Regimes

Obviously, a number of these regimes will create significant changes within the real estate industry, as well as in the broader economy. Many of these implications are described above. It also is important to note there are certain specific tax rules that are particularly relevant to real estate or certain aspects of the real estate industry.

> *The low-income housing credit could be eliminated under the consumed income tax and the sales tax, and has a better chance of surviving under the add-on VAT and the reformed income tax.*

First, under all of the alternative regimes, numerous provisions that are intended to promote social goals would be eliminated. For instance, the low-income housing tax credit would almost certainly be eliminated under the consumed income tax and the national sales tax. Because there is an income tax element that will continue in the add-on VAT and the reformed income tax, the low-income tax housing credit would have a better chance of surviving in these regimes. However, even in those contexts, given the expressed desire to simplify the income tax by eliminating many current deductions and credits, the low-income housing tax credit could cease to exist.

Similarly, many in the real estate industry rely on like kind exchanges in order to defer gain in selling real estate. In the consumption tax regimes (i.e., the consumed income tax, the VAT portion of the add-on VAT, and the national sales tax), there would be no mechanism for deferring liability for the tax, although the consumed income tax would provide the functional equivalent where sales proceeds were reinvested given that a deduction would be provided for the purchase of property. In the reformed income tax regime and the income tax portion of the add-on VAT, the alignment of taxable income with GAAP income probably would lead to the elimination of gain deferral for like-kind exchanges given that no such deferral is provided under GAAP.

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The Real Estate Roundtable

For more information about The Real Estate Roundtable and its mission, please visit their website at www.rer.org or call them at 202-639-8400.

This discussion document was prepared for The Real Estate Roundtable at its request. The paper is intended solely for the internal use of The Real Estate Roundtable members in their discussion of tax reform options and their potential impact on real estate. The document presents neither an exhaustive analysis of pending proposals nor a comprehensive study of their impacts. Instead, the document seeks to identify broad outlines and their effects so the members of The Roundtable can begin the process of identifying priority issues and concerns. As the range of possible approaches is narrowed through the political process, the preparation of detailed analyses and comprehensive studies on those approaches may be appropriate. For additional information, please contact Clint Stretch, Director of Tax Policy, Washington National Tax at 202-879-4935 or cstretch@deloitte.com, or Fred Witt, National Director, Real Estate Tax Services at 602-234-5131 or fwitt@deloitte.com.