The U.S. federal taxation system is constantly evolving. Virtually every new presidential administration attempts to change the tax system. In the past thirty-five years, there have been two major tax reforms, with many smaller changes in between. Tax reforms often confer benefits that make home ownership and commercial real estate ownership more or less attractive and profitable. This Hot Topic Alert provides an overview of some of the most significant tax provisions affecting real estate ownership, including recent changes and new proposals.

What is tax reform?

Tax reform, whether small or large, is an effort by government to improve the tax system. It is driven by a broad range of policy goals, such as improving the efficiency of tax administration, minimizing tax evasion, stimulating the economy, and incentivizing taxpayer investments in certain directions through tax deductions and credits.
Tax measures can significantly influence business and personal decisions. For instance, the U.S. tax code favors real estate ownership. As discussed in more detail below, real estate owners benefit from measures such as the home mortgage interest deduction, depreciation of rental property, and the deferment of capital gains tax for like-kind exchanges of business property. These and other tax benefits encourage home ownership and commercial real estate investment.

**Tax Reform Act of 1986**

The Tax Reform Act of 1986 (TRA) (P.L. 99-514) had several policy goals. It simplified the income tax code, while attempting to increase fairness and incentivize economic growth. The TRA defined the home mortgage interest deduction, reduced the number of income tax brackets, reduced top income tax rates from 50% to 28%, raised bottom rates from 11% to 15%, and raised taxes on long term capital gains. Before the TRA, capital gains and ordinary income were treated differently. Previously, capital gains were taxed at lower rates than regular income and were eligible for partial tax-free treatment. The TRA removed the special treatment for capital gains, mandating instead that they be taxed as ordinary income.

The TRA eliminated a favorable depreciation rate for commercial real estate investments, replacing it with a much slower straight-line depreciation schedule. This ended the ability of taxpayers to offset other income with tax losses from real estate. According to a study by Freddie Mac (the Federal Home Mortgage Corporation), the pre-TRA accelerated depreciation schedules were the primary reason for the real estate boom in the 1980s.

For the real estate sector, the most significant part of the TRA was the enactment of the passive loss rules. These rules restricted the ability of individuals to offset unlimited real estate losses against salaries, wages, and other income. Before the passage of the TRA, individuals could offset active income with passive income losses from a real estate tax shelter. The TRA limited the deduction of passive losses to the amount of passive income. Taxpayers were, however, allowed to carry forward any passive losses in excess of their passive income to the next year.

**Tax Cuts and Jobs Act of 2017**

The Tax Cuts and Jobs Act (TCJA) of 2017 (P.L. 115-97) was the most substantial tax reform since the TRA. Judging the long term effects of the TCJA may be impossible, given the massive disruption of the U.S. and world economies caused by COVID-19 starting in 2020. The TCJA aimed at encouraging companies to locate and invest in the United States by lowering effective tax rates on new investments. It also reduced tax rates for individual taxpayers, and capped or eliminated several itemized deductions, while doubling the standard deduction (to $12,000 for individuals and $24,000 for joint filers) and raising the family tax credit. One effect of the TCJA’s reforms was to significantly reduce the number of taxpayers who itemize deductions on their tax returns. Before the TCJA, about 31% of individual taxpayers itemized their deductions. The Tax Foundation estimates that, after the TCJA, approximately 13.7% itemized deductions for the 2019 tax year.

The TCJA contained many other measures, such as reducing the alternative minimum tax for individual taxpayers and eliminating it for corporate taxpayers. The TCJA is scheduled to expire
at the end of 2025, meaning that virtually all changes would revert back to their pre-TCJA status in 2026 unless Congress reenacts them.

The TCJA includes many provisions affecting the real estate sector, including several measures favorable to commercial real estate owners. The law also includes provisions that will have a serious negative impact on the tax benefits of buying and owning a home, such as the increase in the standard deduction, and the limiting of the state and local tax (SALT) deduction and the mortgage interest deduction. These are discussed in more detail below.

Impact of federal taxation on real estate

The federal taxation system offers benefits to real estate owners by allowing some costs of purchasing and owning a home to be deducted from taxes and allowing deferment of taxation in some cases. For instance, as discussed below, homeowners may deduct some mortgage interest and state and local property tax payments from income taxes. Several of these types of measures are discussed below.

A. Section 1031 like-kind exchanges

The Revenue Act of 1921 (P.L. 67-98) created “like-kind exchanges,” also known as Section 1031 exchanges. See IRC § 1031. A Section 1031 exchange allows deferral of capital gains taxes when the taxpayer exchanges one investment or business-use property for another property of like kind. Under Section 1031 of the Internal Revenue Code (IRC):

No gain or loss shall be recognized on the exchange of real property held for productive use in a trade or business or for investment if such real property is exchanged solely for real property of like kind which is to be held either for productive use in a trade or business or for investment.

This rule allows the business investor to defer capital gains on the sale of real property if the investor acquires new property of equal or greater value within a limited time period. The main benefit of like-kind exchanges is that it allows an investor to increase their ownership portfolios without immediately having to pay federal income tax on the gain from the relinquished property. Thus, the deferred taxes can be reinvested into the replacement property.

B. Home mortgage interest deduction

The home mortgage interest deduction is an itemized deduction, which can only be claimed if a taxpayer itemizes their income tax deductions rather than taking the standard deduction. Before the TRA, there was no limit on the amount of home mortgage interest that a taxpayer could deduct from income taxes. The TRA limited the deduction to: (1) interest on mortgages up to the purchase price, plus improvements, of two homes; and (2) home equity debt used for qualified medical and educational expenses. Shortly after the TRA, the Omnibus Budget Reconciliation Act of 1987 (P.L. 100-203) further narrowed the deduction, limiting its application to: (1) mortgages up to $1
million for up to two homes; and (2) up to $100,000 of interest on new home equity loans (regardless of the use of the proceeds of the loan).

The TCJA further reduced the home mortgage interest deduction by limiting it to new mortgages and home equity loans below $750,000 (combined). The TCJA also specified that the only home equity loans eligible for the deduction are those used to finance expenditures related to substantially improving the home. Qualifying loans incurred before the TCJA are exempted from the lower ceiling, however.

As mentioned above, the TCJA’s simultaneous cap on certain deductions and increase in the standard deduction discouraged many taxpayers from itemizing deductions at all. This change also removed a major tax advantage of home ownership for most taxpayers.

Recent economic analysis suggests that the current home mortgage interest deduction scheme affects the size of the home purchased more than it affects the decision to buy a home in the first place. Additionally, higher-income households are more likely to use the mortgage interest deduction largely because higher income households are more likely to itemize their tax deductions, which means they are more likely to use the mortgage interest deduction; marginal tax rates increase with income, meaning that the deduction saves the higher-income taxpayers more money; and higher-income individuals tend to purchase more expensive homes, resulting in larger mortgage interest payments.

The TCJA does, however, limit the households that will see any tax benefits to buying or owning a home. The increase in the standard deduction means that most middle-income, minority, and millennial households will no longer be able to take advantage of the tax benefits of buying a home. The mortgage interest deduction will be left only to higher income taxpayers. The Tax Foundation estimates that fewer than 4% of taxpayers earning less than $50,000 will claim the deduction and make up 34% of the claims for the deduction and take 60% of the benefits.

C. Exclusion of gain from sale of residence

Taxpayers generally pay capital gains tax on profits from asset sales, such as real estate. However, homeowners enjoy an exception to this rule for their principal residence. Homeowners who satisfy certain criteria may exclude up to $250,000 ($500,000 for joint filers) of capital gain on a home sale. Homeowners may take advantage of this capital gains exclusion if:

- They maintained their home as their principal residence for two of the preceding five years; and
- They did not claim the exclusion for the sale of another home in the last two years.

Unfortunately, these exclusions, which have been in force since 1997, are not tied to increase with inflation. As a way of updating the exclusion to keep pace with increasing home prices, NAR strongly recommends indexing the exclusion amount for inflation.
D. **Depreciation**

Income-producing property, such as rental property, may benefit from tax deductions for depreciation of the value of the rental buildings and improvements (depreciation does not apply to land). The property depreciation deduction is an allowance for the costs of buying and improving the property over its useful life, including deterioration, wear and tear, and obsolescence. Land cannot be depreciated, but buildings can be. The convention for most U.S. residential rental property is annual depreciation of 3.636% annually for 27.5 years.

Additionally, the TCJA introduced an extremely favorable depreciation measure to encourage investment. The TCJA’s bonus depreciation deduction allows businesses to deduct 100% of the cost of certain capital acquisitions, including used property, in the year of acquisition. Before the TCJA, the rate was only 50% and used property was ineligible. For commercial real estate owners, capital acquisitions might mean things like carpeting, new electrical systems, landscaping, and similar improvements on properties.

E. **Foreign Investment in Real Property Tax Act (FIRPTA)**

Up until 1981, foreign people (individuals and corporations) who owned real estate in the U.S. were often exempt from U.S. tax on the sale of that real estate. With the passage of the Foreign Investment in Real Property Tax Act (FIRPTA) in 1980 (Title XI, Subtitle C, of the Omnibus Reconciliation Act of 1980 (Pub. L. 96-499)), however, that exemption ended. Under FIRPTA, all foreign persons must pay tax on dispositions of any interests in U.S. real estate. In order to ensure tax collection, buyers are generally required to withhold 15% of the sales price. NAR generally views FIRPTA favorably, based on the principle that foreign investors should be subject to similar tax rules as U.S. investors.

F. **State and local tax (SALT) deduction**

When calculating federal taxes, the federal tax law allows filers who itemize their deductions to deduct certain state and local taxes (SALT). In order for the tax to be deductible, the state or local authority must impose the tax on the taxpayer and the taxpayer must pay it during the tax year. In another move that neutralized some of the benefits of homeownership and reduced the incentive for many taxpayers to itemize deductions, the TCJA capped the SALT deduction at $10,000. This limit also imposes a serious marriage penalty in that single and joint filers are subject to the same $10,000 cap.

To be deductible, the state or local tax must be uniform against all real property in the jurisdiction at a like rate; the deduction is not allowed for taxes associated with a specific improvement benefitting only the taxpayer’s home. For example, many state and local governments have approved loan programs to finance energy saving home improvements. Such loans may be secured by a lien, which appears as a special tax. These types of special assessments or taxes are not deductible from federal taxes.

G. **Estate taxes**
Federal estate tax is a contentious issue. The laws governing estate tax have changed at least twelve times since 2001. The TCJA raised the estate tax exemption – the amount of estate assets exempt from taxation – to $11.7 million in 2018, to be adjusted each year for inflation. This is about double the previous exemption. The rate of estate tax for amounts over the exemption ranges from 18% (for taxable amounts from $0 to $10,000) to 40% (for taxable amounts more than $1 million). Thirteen states (including Washington, D.C.) also have similar levies, generally called inheritance taxes. However, assets that spouses inherit generally aren’t subject to estate tax.

H. Section 199A Qualified Business Income (QBI) Deduction

Under a safe harbor created by regulations pursuant to the TCJA, income generated from certain interests in real estate may be eligible for a partial deduction as qualified business income (QBI). Under the new IRC § 199A, which the TCJA created, a “rental real estate enterprise,” defined as an interest in real property held to generate rental or lease income, and that meets enumerated requirements, may be able to deduct up to 20% of their QBI from taxable income. The Section 199A QBI deduction also includes up to 20% of qualified real estate investment trust (REIT) dividends.

Some of the requirements for the safe harbor for rental real estate enterprises include:
- Separate bookkeeping for the enterprise; and
- Performing (or directing the performance of) at least 250 hours of rental services per year performed by the taxpayer or others.

I. Qualified Opportunity Zones

The TCJA also created qualified opportunity zones (QOZ) to encourage growth in underserved communities by offering tax benefits for investment in them. This new tax-saving tool offers incentives for investment in thousands of low-income communities in all 50 states, Washington, D.C., and five U.S. territories. Taxpayers who invest in a QOZ through a qualified opportunity fund (QOF) can temporarily deter tax on eligible gains that they invest in the fund.

Eligible gains include capital gains and qualified gains from business property sales other than gains from a transaction with an interested person. To qualify for the QOZ benefit, the taxpayer must invest in the QOF in exchange for equity (not debt) interest in it within 180 days of realizing the gain. The QOZ benefit defers capital gains tax until 2026. In 2026, if the investment has been held for five or more years, then 10% of the gain is tax free. If the investment is held for ten years or more, there is no capital gains tax on its appreciation.

J. Independent contractors

Most real estate agents have a special tax status. The IRS classifies them as statutory nonemployees. The following conditions apply to this status:
- The agent is a licensed real estate professional;
- Substantially all payments for the agent’s services are directly related to sales, rather than hours worked; and
• They work under a contract stating that they will not be treated as employees for federal tax purposes.

This classification means that the agent may be treated as an independent contractor, rather than an employee of the agent’s supervising broker. If the agent meets the three requirements outlined above, the broker need not contribute a share of the agent’s Social Security and Medicare taxes and no federal income taxes need to be withheld from the agent’s earnings.

As an independent contractor, the agent must fulfill self-employed tax obligations, including:
• Pay quarterly estimated income tax;
• Pay self-employment tax (the Social Security and Medicare taxes that are normally shared between employee and employer); and
• Report full gross income from real estate and allowable business expenses.

NAR supports the ability of real estate brokers to classify their agents as either employees or independent contractors.

Tax reform proposals

President Biden has proposed federal tax reforms for 2022 that could significantly affect the real estate sector. Known as the American Families Plan (AFP), the proposal would limit several important deductions and benefits for the real estate sector.

For instance, under current law, like-kind exchanges under Section 1031 do not have a dollar limit. The AFP would cap the deferral of capital gains from like-kind exchanges on real estate to $500,000 ($1,000,000 for joint filers).

As for estate taxes, although the AFP would not change the current estate tax of 40% on assets above $11.7 million per person, it would impose a tax on unrealized gains on assets upon transfer by gift or death. Ordinarily, the cost basis of an inherited asset is adjusted to the fair market value upon the owner’s death (known as a “step up in basis”). This enables heirs to avoid paying taxes on gains in inherited real estate that accrued before the decedent died. The AFP would require a decedent’s estate to pay the capital gains tax upon the death of the decedent, and would eliminate the step up for unrealized gains of over $1 million per person ($2 million for joint filers).

The AFP would also increase the top rate for capital gains from 20% to 37%. According to the Biden administration, this would only affect taxpayers whose incomes exceed $1 million ($2 million for joint filers). The AFP would also eliminate the capital gains treatment for carried interests, treating them instead as ordinary income, subject to income tax and self-employment taxes. These increases in capital gains taxes could have a dramatic negative impact on future investment in the real estate industry.

Other legislation currently being considered by Congress would address the lack of affordable housing that affects many areas of the country. The Build Back Better Act (H.R. 5376) includes an expansion of the Low Income Housing Tax Credit. The Credit gives state and local agencies the authority to issue tax credits for the acquisition, rehabilitation, or new construction of rental
housing targeted to lower-income households. The Build Back Better Act would increase the state allocation of credits at a rate of 10 percent per year plus inflation through 2024. As of November 8, the Build Back Better Act is pending in the House of Representatives.

State legislation

Property and estate taxes are the primary state tax measures affecting the real estate sector. A few significant changes in these areas of state tax came into force in 2021.

For instance, the repeal of a state constitutional amendment in Colorado removed a limit on the percentage of residential property making up the state’s property tax base. The repeal permits the state to increase residential property tax rates.

Washington, D.C., imposed an estate tax from 11.2% to 16% on estates valued at more than $4 million (to be adjusted annually for inflation). Previously, the tax applied to estates valued at more than $5.7 million.

In Connecticut, a person who sells real estate for at least $2,000 must pay a tax on the transfer from 1% to 2.75%. However, taxpayers hit by this tax may now qualify for an income tax credit. Taxpayers who pay the transfer tax at the top rate and who remain in the state following the sale of the property may be eligible for tax credits starting the third year after the sale. Over the following three years, the tax credits will cover the amount of transfer tax paid.

NAR efforts

NAR seeks to preserve and extend the tax benefits of homeownership and real estate investment. NAR has achieved significant recent victories in the area of federal taxation affecting the real estate sector. For instance, NAR successfully campaigned for relief from taxation of mortgage debt forgiveness from 2021 to 2025. Under the general tax rule, the amount of debt forgiven is treated as taxable income to the borrower. Under an extension enacted at the end of 2020, the forgiven debt is not treated as income. This provides a needed tax relief to borrowers forced to seek mortgage forbearance and assistance during the COVID-19 pandemic.

Additionally, NAR is engaged with the Biden administration and Congress in addressing the proposed tax reforms in the AFP. NAR believes that several of these proposals will harm economic growth, particularly in the commercial real estate industry.

For instance, the AFP’s proposed cap of $500,000 per taxpayer per year on Section 1031 like-kind exchanges would greatly diminish the use of Section 1031 and damage the real estate industry. NAR is actively opposing the cap, including sponsoring studies on the impact of the proposal on the economy and the real estate sector and alerting Congress to the dangers of the proposal.

NAR also opposes the AFP proposal to increase the capital gains tax rate. Lowering capital gains tax rates can incentivize investment. Raising these rates could freeze portions of the market. It could also discourage larger real estate investment projects, since the returns on these projects will be reduced by the increased tax. The AFP proposed tax on unrealized capital gains at death would
also be harmful. This proposal essentially creates a second estate tax, with much lower thresholds, which could force many families to sell properties upon inheritance in order to pay the tax.

Available NAR Resources

NAR’s federal issues tracker provides up-to-date information on a range of issues affecting the real estate sector, including federal taxation. For each issue, the tracker summarizes the fundamental issues, analyzes their importance for real estate professionals, sets out NAR policy and opposition arguments, and gives an outlook of pending legislation and regulation. NAR also provides regular legislative and regulatory updates on these issues.

NAR also publishes the Washington Report, providing analysis of current legislative and regulatory policy activities. It includes news on NAR advocacy activities. For instance, NAR sent a letter to House and Senate tax committees on September 7, 2021, pointing out that proposed limits on tax benefits for real estate investment in the AFP would only worsen the nation’s affordable housing crisis.

Other Organizations Working on this Policy

Americans for Tax Reform: a nonprofit, taxpayer advocacy group fighting to minimize and simplify taxation.

Tax Policy Center: a joint venture of the Urban Institute and Brookings Institution, this group of experts provides analysis and facts about tax policy, such as model estimates, research, and commentary.

Tax Foundation: a leading independent tax policy nonprofit, providing expert research an analysis.

Association of International Certified Professional Accountants: an association representing certified professional accountants worldwide, primarily concerned with professional standards, it also advocates on rule-making and sound tax policy before legislative bodies.

National Multifamily Housing Council: an association of apartment industry leaders, such as owners, managers, and developers, helping to create thriving communities.

National Apartment Association: a leading voice for the rental housing industry, with 149 state and local affiliates.

Landlord Association: a network of landlords and real estate professionals providing valuable information, knowledge, and resources.

Mortgage Bankers Association: a leading advocate for the real estate finance industry.

Conclusion

The federal tax system has a major impact on individual decisions within the real estate sector, such as whether to own a home, or whether to invest in commercial real estate. When tax law
allows deductions associated with real estate, such as the home mortgage interest deduction and the QBI deduction, this encourages ownership and investment. When the TCJA came into force in 2018, it neutralized some of the tax benefits of homeownership while increasing the benefits of commercial real estate investment. The newest batch of tax proposals in the AFP would remove several incentives for real estate investment, potentially damaging this important sector of the economy. NAR continues to work closely with its members and lawmakers to protect and encourage homeownership and commercial real estate investment.
ADDITIONAL STATE & LOCAL RESOURCES

White Papers: Comprehensive reports prepared for NAR on issues directly impacting the real estate industry. Examples include: Rental Restrictions, Land Banks, Sales Tax on Services, State & Local Taxation, Building Codes, Hydraulic Fracturing, Foreclosure Property Maintenance, Climate Change, Private Transfer Fees.

Growth Management Fact Book: Analysis of issues related to land use and modern growth management topics include density — rate of growth, public facilities and infrastructure, protection of natural resources, preservation of community character, and affordable housing.

All available on REALTOR® Party webpage under the State & Local Issues tab.