

Energy

Issue: Climate change is the number one environmental issue in Congress, and has certainly been heard on the Presidential campaign trail. In the next several years, it is expected that the White House and Congress will make it a priority to pass legislation that will lead to a reduction in greenhouse gas emissions. Such legislation could affect the cost of constructing new and retrofitting existing buildings and the cost of operating multifamily and commercial structures.

However, when contemplating “zero-net” energy buildings or the like, Congress has tended to ignore the difficulties of retrofitting existing buildings, and instead focused on new construction. It is significantly easier to design and construct new energy-efficient buildings compared to retrofitting existing buildings. However, a great deal of proposed legislation and regulation ignore this difference and would apply to all buildings – new or existing.

Legislation to extend the energy efficient tax credits beyond the end of FY08 has been moving in Congress. IREM and CCIM Institute believe that incentives for energy efficiency investments are the best way to promote conservation. While many proposals threaten to require mandates for green buildings and “zero-net” energy, we believe positive incentives are the better way to achieve the goal.

Position: Recognizing the serious concerns of global warming, IREM and CCIM Institute support the development of voluntary standards for reducing greenhouse gas emissions. We support the use of sustainable materials in the construction of buildings, and programs that reduce the “carbon footprint” of real estate assets. However, requirements to retrofit existing buildings must take into consideration the needs of these buildings and costs associated with such changes. Additional research is necessary to determine to what level greenhouse gases are affecting the environment versus natural climactic changes humans cannot control.

IREM and CCIM Institute strongly support positive incentives for energy conservation activities. Specifically, we strongly support energy tax credits and voluntary programs like Energy Star, which includes the program formerly known as the EPA’s “Green Lights program.” IREM and CCIM Institute urge Congress to focus on voluntary standards for new construction and existing properties.

Your Experiences: Today, commercial buildings make up 73 billion square feet of real estate in this country. Our lawmakers need to understand the benefits of market-based incentives to retrofit existing buildings for energy efficiency and the serious consequences to mandating the same. In your Capitol Hill Visits, we urge you to bring to them an example of a real or proposed energy efficient retrofit for your properties. When deciding what personal experience to share, think about the following:

- Costs of energy efficient improvements in existing buildings
 - New light bulbs vs. new HVAC or other major systems
- Your holding period for these properties versus the depreciation
- Passed-on costs to tenants or residents (i.e. rent increases or lease escalators)

- Bias against existing buildings versus new construction – how to compete for rents with increased costs
- What is the benefit for property owners

Opposing Views: Some believe that mandates are the only way to combat global warming and the costs associated with them should not be an issue. From a federal budgeting standpoint, tax credits are costly. The Administration and many Republicans oppose H.R. 5351, which would deny tax deductions to certain oil and gas producers.

Status: In late February, the House passed H.R. 5351, the “Renewable Energy Conservation Tax Act of 2008” by a largely partisan vote of 236-182. This bill extends tax incentives for energy efficiency in commercial buildings, use of efficient home heating and cooling equipments, production of efficient home appliance, and efficiency retrofits to existing homes. The commercial building credit was extended through 2013. It also allows a five-year recovery period for the depreciation of qualified energy management devices.

Similar legislation has not yet been introduced in the Senate.

Natural Disaster Insurance

Issue: Affordable and accessible insurance is essential to the real estate market. Property and casualty coverage is an underwriting requirement for conventional, government-assisted and commercial mortgages. Insurance, in its various forms, has been the subject of numerous hearings and pieces of legislation in Congress. Insurance regulatory reform, flood insurance, disaster policy, and terrorism insurance will all be “on the table.”

The intensity of large natural disasters in recent years has made the acquisition of adequate property insurance very difficult in some areas. Historically, insurers were declining to write policies, canceling policies, and increasing premiums. Recently, Hurricanes Katrina and Rita have refocused attention on this issue. The viability of the insurance market is critical to real estate financing. Both commercial and multifamily properties should be covered in addition to homeowner’s insurance.

Position: IREM and CCIM Institute are very concerned about the availability and affordability of property insurance. When property owners cannot obtain insurance, the entire real estate market is at risk. A healthy real estate economy is vital to our national interest. We urge Congress to develop a solution to this problem. A federal reinsurance program that is funded through contributions from insurers or state catastrophic insurance programs will help communities recover from disasters while preventing taxpayers from bearing many of the costs associated with such disasters.

Opposing Views: Opponents argue that federal support of the insurance industry will result in a repeat of the savings and loan crisis, or that property owners in non-disaster-prone areas will have increased costs to cover those in disaster-prone areas.

Status: In November of 2007, the House of Representatives passed H.R. 3355, the Homeowners' Defense Act of 2007. The bill, which was introduced in August by Representatives Ron Klein (D-FL) and Tim Mahoney (D-FL), is designed to help address the availability and affordability of homeowners insurance in disaster-prone areas. The bill creates a federal program to provide loans to states impacted by natural disasters. The bill also allows state-sponsored disaster prone areas to pool their risk with other states, and then transfer the risk to the private market through the issuance of bonds.

However, this legislation fails to address the issues of commercial property insurance. A companion bill, S. 2310, has been introduced in the Senate.

In addition, S. 2286, the "Commission on Natural Catastrophe Risk Management and Insurance Act of 2007," was introduced by Senator Dodd and passed by the Senate Banking Committee on August 1, 2007. The bill establishes a bi-partisan commission to study and report back to Congress with recommendations for address property insurance availability and affordability by December 1, 2008. However, this bill has not yet been considered by the full Senate.

Leasehold Improvements

Issue: Permanent federal law requires leasehold improvements to be depreciated over a 39-year period. A provision that allowed those costs to be recovered over 15 years expired at the end of 2007. The 15-year life has been a "temporary" provision for several years. That rule is not controversial, but was lumped into a package of about 20 expiring provisions that were not renewed in 2007. A timetable for reviewing and renewing that package of expired provisions has not been set.

In the interim, during 2008 property owners (or their tenants, depending on the arrangement) may elect to take an immediate deduction for 50% of the costs associated with leasehold improvements. This "bonus" depreciation was included in the Economic Stimulus Act of 2008. Taxpayers who do not elect bonus depreciation may choose instead to deduct as much as \$250,000 of the cost of otherwise depreciable property that is acquired and placed in service during 2008. Unfortunately, these provisions are limited to this year. Thus, commercial real estate professionals are requesting that Congress provide for similar deductions in the coming years.

The rate of return for investors is diminished because the cost recovery period for real estate is so long. A shorter recovery period for real estate would improve rates of return for assets. In addition, investment in real estate would be more economically viable for potential investors. Shorter depreciation periods do, however, increase the amount of gain on sale that is subject to depreciation recapture taxes of 25%.

The permanent law 39-year recovery period for interior building improvements is not economically realistic. Neither the leases nor the improvements are likely to last that long. When a landlord improves space to attract a new tenant, elements such as electric wiring and cable, technology infrastructure, walls, kitchens and rest rooms are upgraded and reconfigured to suit the new tenant. By their nature, these improvements are unlikely to last for 39 years. Nonetheless, because these elements are part of the structure itself, the costs for them must be amortized over 39 years. Similarly, the usual term for leases varies between 8 and 15 years. Before 1981, tenant improvement costs were amortized over the life of the lease.

The benefits of lessening the cost-recovery period for leasehold improvements extend beyond that of the property owner. A realistic cost recovery period, such as 10 or 15 years, provides an incentive for building owners to upgrade and improve their space. With increasing competition between suburban and downtown space in many markets, older space must be more economically viable. A realistic cost recovery period for tenant improvements to a building will increase the rate of return on all buildings, including older commercial and retail space. In addition, tenant improvements and building upgrades provide jobs in all communities. Thus, this change creates a more level playing field and stimulates local economies.

Position: IREM and the CCIM Institute support efforts to measure more accurately the depreciable life of buildings and to conform amortization periods of tenant improvements more closely to the term of the lease. The current 39-year time frame does not accurately reflect the useful life of a building and its components.

IREM and the CCIM Institute support depreciation reform for nonresidential and residential real estate that secures a significantly shorter cost recovery period for commercial real estate without adding complexity or creating artificial acceleration of deductions.

IREM and the CCIM Institute support legislation to decrease the length of depreciable lives for tenant improvements. Specifically, legislative language that would allow the remainder of tenant improvement costs to be written off upon the expiration of a lease, not over the depreciable life of a structure.

IREM and the CCIM Institute support legislation that would reduce the tax on depreciation recapture to the capital gains tax rate of 15%.

Opposing Views: No opposing views are identified, and Congress has reached consensus that the 39-year recovery period is too long. This proposal will likely be debated against other tax cuts because of its cost to the federal government.

Status: H.R. 2014 and S. 1361, both titled the “Leasehold Improvement Depreciation Act of 2007,” would make permanent the 15-year recovery period for leasehold improvements.

Capital Gains/Depreciation Recapture

Issue: Under current law, capital gains are taxed at a maximum rate of 15%. This rate is temporary and will revert to 20% as of January 1, 2011. When capital gains tax rates were reduced to 15% from 20% in 2003, the depreciation recapture rate remained at 25%. Before 1997, depreciation recapture amounts were taxed at the same rate as capital gains.

Favorable capital gains tax rates provide a stimulus for owners who wish to sell appreciated property. Lower rates relieve the so-called "lock-in" effect, in which taxpayers are unwilling to sell property because of high tax costs associated with sales. Lower capital gains rates also mitigate in part the built-in gain that arises from inflation.

The "gain" on the sale of real estate often is due to extrinsic factors – not excessive tax depreciation. The building itself does, in fact, depreciate over time like any other wasting asset. Real estate is very capital and maintenance intensive as the building shell and interior components constantly deteriorate and wear out requiring their upgrading or replacement.

Gains in real estate often are attributable to inflation, appreciation in the value of the land, road and other transportation improvements and the marketplace and economy in general. Applying a recapture rate to this appreciation higher than the capital gain rate is inappropriate because the appreciation is capital gain. Such treatment would discriminate against real estate relative to other assets and put real estate at an even greater competitive disadvantage for investment dollars.

The 1997 depreciation recapture changes exacerbated the disparity in tax treatment between real estate and other assets. Another reduction in the capital gains rate without, at a minimum, the proportionate reduction in the recapture rate, would make this disparity even more pronounced. CCIM Institute and IREM urge Congress, therefore, to be mindful of the recapture implications created by further capital gains rate reduction. CCIM Institute and IREM believe revisiting the capital gains issue presents an opportunity to redress the inappropriate recapture treatment imposed in 1997. At a minimum, Congress should act to ensure that that real estate is not further disadvantaged relative to other assets by making reductions in capital gains and depreciation recapture rates proportionate.

Position: CCIM Institute and IREM believe that it is in our nation's best interest for Congress to encourage real estate investment in the United States by creating a tax system that recognizes inflation and creates a meaningful differential between the tax rates for those who choose to invest in real estate and those for capital gains. CCIM Institute and IREM supports a level playing field for those who choose to invest in real estate and thus oppose rates for depreciation recapture that are higher than the capital gains rate.

Further, CCIM Institute and IREM support depreciation reform for nonresidential and residential real estate that secures a significantly shorter cost recovery period for commercial real estate without adding complexity or creating artificial acceleration of deductions.

Opposing Views: Some believe that depreciation recapture should be taxed as ordinary income because the original deductions reduce ordinary income.

Status: The current capital gains rate of 15% will revert to 20% on January 1, 2011. Congress is likely to be reviewing these laws in the coming years.