NAR Issue Brief
Top 10 Things for REALTORS® to Know About the Camp Tax Reform Proposal

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On February 26, House Ways and Means Committee Chairman Dave Camp (R-MI) released his long-awaited plan to reform the federal tax system. The plan was released as a discussion draft only, rather than as an introduced bill. Thus, the proposal is not a legislative vehicle that is likely to move through the House or the Senate this year. However, its provisions are important because Members of Congress could endorse them and possibly include them in a future tax reform bill that is more viable.

Background. Chairman Camp and his staff undertook the process of reforming the tax code more than two years ago with three ambitious objectives in mind:

- Lower the top tax rates for both individuals and businesses to 25 percent;
- Achieve revenue neutrality, meaning that the tax system would continue to deliver to the Treasury the same amount of revenue as under the current tax law; and
- Keep the progressivity of the current tax system intact. This means that various income groups would continue to pay roughly as much tax under the new system as under the old.

Tax policy experts have been watching for the release of the Camp plan for some time, and have been very skeptical that he would be able to achieve all of these goals. Based on the information we now have, it appears that Chairman Camp may have largely achieved the second and third goals, but he was not able to meet the first one.

Tax Rates. For the great majority of taxpayers, the Camp plan does offer a top rate of 25 percent. In fact, it would repeal the current law's seven rate structure and replace it with just three brackets – 10 percent, 25 percent, and 35 percent. The new highest bracket would be for single taxpayers with incomes above $400,000 and for joint filers with incomes above $450,000. Moreover, those in this new highest tax bracket would be subject to tax on income that is exempt under the current law, including tax-exempt interest and employer contributions to health insurance. Also, these higher income taxpayers would be limited in their ability to take deductions against income taxed at the 35 percent rate. The effect of these changes makes the marginal top tax rate much higher than 35 percent.

Capital Gains. The Camp plan also modifies the way capital gains are taxed, but for most taxpayers, the top rate will stay at 15 percent. The proposal would exclude 40 percent of capital gains income from taxation, and tax the remaining 60 percent at the ordinary income rate. This would result in a capital gains tax rate of 6 percent for those in the 10 percent bracket and a 15 percent rate for those in the 25 percent bracket. Higher-income taxpayers who are subject to the new 35 percent bracket would face a tax rate of 21 percent on capital gains. When combined with the 3.8 percent tax on net investment income, which remains under the Camp plan, the top rate on capital gains would be 24.8 percent.

As we learn more about the Camp tax reform plan and how it would affect real estate, we will have more detail and analysis.

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Proposals Affecting Homeowners:

1. **Increase the Standard Deduction.** The Camp plan would consolidate the current-law standard deduction and the personal exemptions into one larger standard deduction. For single taxpayers, the standard deduction would be increased from today's level of $6,200 to $11,000 and for married couples filing jointly it would increase from today's amount of $12,400 to $22,000.

   Impact on Real Estate. While this may appear to be a positive change, it would be devastating to the current tax incentives for homeownership. This is especially true when combined with the repeal of the state and local tax deduction (discussed below). The effect would be to greatly diminish the number of Americans who can receive a tax benefit for owning their own home. The materials supplied by Chairman Camp indicate that the number of taxpayers who would be able to itemize would drop from today's rate of about one in three to about one in twenty. <u>Thus, for most Americans, home ownership would have no tax advantage over renting.</u>

2. **Repeal the Deduction for State and Local Taxes.** The Camp proposal would repeal the deduction for state and local taxes paid (unless paid or accrued by a business or by someone owning rental property).

   Impact on Real Estate. The plan would eliminate one of the major tax incentives available today for owning one's home – the ability to deduct real estate taxes. Even worse, its repeal would significantly decrease the number of homeowners who would have enough deductions to itemize them on their tax returns because individuals would also lose the ability to deduct state and local income or sales tax. When this is combined with the increase in the standard deduction, it strikes a massive blow to the current law's incentives for homeownership. The impact would be especially devastating in states with higher income and property taxes, where home values could see an even bigger downturn.

3. **Limitation on Deductibility of Mortgage Interest.** The Camp plan would reduce the current law's mortgage loan limit from $1 million to $500,000 in four annual increments of $125,000 each. Thus, for the first year, the limit would be reduced to $875,000, for the second, it would be $750,000, and so forth. This would apply to debt incurred after 2014, and older mortgages would be grandfathered. In addition, interest on new home equity loans would no longer be deductible. As with the current law's $1 million limitation, the new $500,000 limit would not be indexed for inflation.

   Impact on Real Estate. Compared with the other changes discussed above, the impact of the lower limit on mortgage debt that is eligible for deductibility would be fairly limited in the short term in most real estate markets. For higher priced markets, the effect would be immediate and very negative for new home purchases in the higher ranges of homes. However, it is in the long run where this provision becomes more harmful. Because real estate prices are projected to grow over time, an unindexed threshold of $500,000 would eat away at the value of the deduction. NAR's conservative estimates project one quarter of U.S. homes will have values above $500,000 within ten years.

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4. **Exclusion of Gain from Sale of Principal Residence.** The Camp plan would modify the current-law exclusion to provide that instead of the home having to be owned and used as the taxpayer's principal residence for at least two out of the previous five years, the property would have to be owned and used by the taxpayer as his or her principal residence for at least five of the previous eight years. Moreover, the modification also would limit the use of this provision to once in every five years, from today's rule of once every two years. Finally, the exclusion would be phased out for higher-income taxpayers (those with modified adjusted gross incomes exceeding $500,000 for joint filers and $250,000 for singles).

   Impact on Real Estate. The changes proposed by this provision would punish millions of homeowners who found themselves needing to sell their home because of a change in employment or other reasons if they happen to not have lived in the home for at least five years. This could also affect economic growth as it would decrease the mobility of the workforce. Also, because the thresholds remain unindexed under the proposal, over time the value of the benefit will greatly diminish.

5. **Mortgage Debt Forgiveness.** The Camp plan does not include any mention of the tax treatment of discharge of mortgage indebtedness. The draft expressly repeals other so called "extenders" which have been temporary parts of tax law. However, the draft also does not make the provision permanent. Thus, it is not clear what Chairman Camp's intentions might be for this important provision.

   Impact on Real Estate. NAR will seek clarification from the Committee as to its intentions for mortgage debt forgiveness. The good news is the provision is not expressly repealed, but the lack of its inclusion as a permanent provision, something NAR has pushed for, is troubling.

Proposals Affecting Commercial Real Estate and Investment Property:

6. **1031 Like Kind Exchanges.** The Camp plan completely repeals the rules allowing deferral of gain on like-kind exchanges. The proposal would be effective for transfers after 2014. However, a like-kind exchange would be permitted if a written binding contract is entered into on or before December 31, 2014, and the exchange under the contract is completed before January 1, 2017.

   Impact on Real Estate. The current like-kind exchange rules allow taxpayers to defer capital gains in property by exchanging it for similar property. Like-kind exchanges allow capital to flow more freely among investments and are critical to economic growth and job creation. Repealing these rules would remove liquidity from the real estate market, limit the number of transactions, and generally increase the taxation of real estate.

7. **Depreciation.** The Camp plan would repeal the current modified accelerated cost recovery system (MACRS), which currently provides a depreciable life of 39 years for non-residential real estate and 27.5 years for residential real estate. In its place, the plan provides a statutory 40-year life for <u>all</u> depreciable real estate, using the straight-line method. The provision would be effective for property placed in service after 2016. Thus, current law would apply to property placed in service during 2014, 2015 and 2016.

Impact on Real Estate. Although the Camp plan increases the statutory depreciable life for real property, it does so only on a prospective basis. Thus, property currently being depreciated would continue to follow its original schedule. Other recent proposals, including one released last November by former Senate Finance Chairman Max Baucus, propose cost recovery periods for real estate that are even longer than under the Camp proposal (43 years), and even worse, would be retroactive for property already in place. Even so, the Camp proposal represents a move in the wrong direction and leaves real property to be depreciated over a period greatly in excess of its actual economic life.

8. **Depreciation Recapture.** Under the current law, the portion of gain on the sale of real property that is equal to the amount of previously-taken depreciation is taxed as capital gains income, at a special rate of 25 percent. The Camp proposal would treat such income as ordinary income, which would be taxed at the top tax rate of the taxpayer (up to 35 percent under the proposal). However, this would apply only to depreciation taken after 2014.

   Impact on Real Estate. Higher-income taxpayers who have gains from the sale of real property will face a significant tax increase under this proposal. Nominally, the increase would be from 25 percent to 35 percent. However, because the Camp proposal also broadens the income base to which tax applies for those in the 35 percent bracket, the impact could be far greater.

9. **Carried Interest.** Under the Camp plan, certain partnership interests held in connection with the performance of services would be subject to a rule that characterizes a portion of any capital gains as ordinary income. This rule would apply to partnership distributions and dispositions of partnership interests. <u>However, the proposal would not apply to a partnership engaged in a real property trade or business.</u>

   Impact on Real Estate. NAR has long argued that the activities associated with partnership interests for real estate development are fundamentally different than the activities engaged in by private equity partners or hedge fund managers. The exclusion of real estate from the proposed carried interest rules should be viewed as a validation of the unique role real estate partnerships play in economic development.

Proposed Changes Possibly Affecting REALTORS®

10. **Determination of Worker Classification/Independent Contractor Status.** The Camp plan reaffirms the special designation for qualified real estate agents as independent contractors under section 3508, while attempting to clarify the worker classification status of those who fall outside of the statutory rules.

    Impact on REALTORS®. The fact that the Camp proposal does not attempt to change the statutory independent contractor status of qualified real estate agents is good news. However, agents and brokers should be aware that many challenges to this status are arising at the state level. Agreements should be carefully reviewed to ensure that state labor laws are satisfied.

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Other Proposed Changes in the Camp Plan to Watch

There are a number of other proposals in the Camp plan that could affect real estate, REALTORS® business structures, and local REALTOR® Associations. NAR is continuing to review the Camp Plan to further understand these proposals. Some of these include:

- Repeal of exception to 10-percent penalty for early distributions from IRAs for first-time home purchases;
- Repeal of mortgage credit certificates;
- Modifications to the Low-Income Housing Tax Credit;
- Change in rules determining net earnings from self-employment for purposes of self-employment tax;
- Repeal of certain exceptions to the installment sales rules for sales of farm property, timeshares, and residential lots;
- Repeal of deduction for personal casualty losses;
- Repeal of deduction for moving expenses;
- Modifications of deduction for Social Security taxes in computing net earnings from self-employment;
- Permanent extension of expensing of depreciable business assets for small businesses;
- Further limitations on entertainment expenses;
- Repeal of the tax credit for smaller firms (including nonprofits) that provide health insurance coverage to employees;
- Changes to charitable contribution rules governing donations of qualified conservation easements;
- Repeal of credit for nonbusiness energy property (this provision has expired);
- Repeal of credit for residential energy efficient property;
- Repeal of alternative fuel vehicle refueling property credit;
- Repeal of deduction for energy efficient commercial buildings (this provision has expired);
- Repeal of the new energy efficient home credit (this provision has expired);
- Repeal of the energy efficient appliance credit (this provision has expired);
- Repeal of the tax credit for rehabilitating old and/or historic buildings.

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