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January 17, 2014

The Honorable Max Baucus
Chairman
Senate Committee on Finance
215 Dirksen Senate Building
Washington, DC 20510

Dear Mr. Chairman:

On behalf of the International Council of Shopping Centers (ICSC), I would like to thank you for your efforts in support of fundamental tax reform. Founded in 1957, ICSC is the premier global trade association of the shopping center industry, representing more than 60,000 shopping center owners, retailers, developers, managers, marketing specialists, investors, professional service providers and brokers, as well as academics and public officials.

We appreciate the opportunity to comment on the proposed reforms included in the Senate Finance Committee staff discussion draft (the "Cost Recovery Proposal"). ICSC agrees with the goals of tax reform: to simplify the tax code; lower effective tax rates; encourage small businesses; and spur economic growth. Our comments are intended to identify proposals that we believe would operate against these goals by undermining the U.S. retail real estate industry and the broader U.S economy.

To illustrate the impact of retail real estate on the U.S. economy, in 2012, shopping center related employment contributed to 12.4 million jobs, or 9.2% of total employment nationwide. According to CoStar Realty Information, Inc., there were 112,874 shopping centers with 7.5 billion square feet under roof. Additionally, the latest data from the National Council of Real Estate Investment Fiduciaries and the National Association of Real Estate Investment Trusts, reports that retail real estate had a market capitalization of $80 billion, which does not include any private investment and could potentially double this amount.

ICSC members have significant concerns about how the Cost Recovery Proposal would impact retail real estate. Specifically, our members are troubled by how the proposed reforms will impact capital formation and disadvantage investment in retail real estate in general, but especially as compared to other investment opportunities. Collectively the changes included in the Cost Recovery Proposal could have an extraordinarily harmful effect on U.S. retail real estate activity, the valuation of underlying assets, the financial institutions that are invested in retail real estate, and the economy as a whole.

Based upon a member-wide survey conducted in December 2013, ICSC members responded with explicit concerns about proposals to: (1) raise the tax rates on real estate depreciation recapture; (2) repeal 1031 like-kind exchange rules; (3) eliminate 15-year leasehold improvement depreciation; (4) lengthen the general depreciation recovery periods of real estate to 43 years, well beyond the physical life of assets. In addition, our membership also singled out the proposals to capitalize 50% of advertising costs and eliminate tax incentives for energy-efficient buildings.

ICSC believes it is essential that Congress consider the impact of the proposed tax reforms on retail real estate in order to avoid unintended, and potentially devastating, consequences as described below. As you are aware, the tax changes included in the 1986 Tax Reform Act proved extremely harmful to the commercial real estate industry. It is ICSC's hope that the Senate Finance Committee will work to ensure that future tax reform legislation will not repeat the mistakes of the 1986 Tax Reform Act with respect to the taxation of real estate. Our membership is committed to actively participating in the debate to help ensure that changes to the tax code do not disproportionately impact our industry.

Under current law, many of ICSC's members are not subject to corporate taxes, since they are generally organized as pass-through entities or as Real Estate Investment Trusts ("REITs"). Because much of the real estate industry would not directly benefit from the promise of lower corporate tax rates, the proposed reforms will materially and disproportionately harm real estate, with consequences reminiscent of the real estate collapse that occurred post-enactment of the 1986 Tax Reform Act.

Furthermore, ICSC strongly believes that significant attention should be given to reducing the retroactive impact of the proposed reforms on existing investments. Any changes in real property depreciation rules should only apply to property not yet "placed in service". As well, we believe that the cumulative negative effects of the base broadening proposals (the Cost Recovery Proposal combined with other tax reform proposals) should be taken into account and balanced against the cumulative benefits to each industry and taxpayer class.

ICSC is particularly troubled that a compilation of multiple revenue raisers without a clear rate offset to individual taxpayer rates will disproportionately harm real estate, which, as previously noted, is typically held through pass-through entities. Thus, we request that tax rate reductions be applicable to both corporations and individuals, and that capital gains rate preferences be preserved. Finally, ICSC calls for the Finance Committee's thorough consideration of workable transition rules that will minimize market disruption.

Individual provisions of the Cost Recovery Proposal

Taxation of Depreciation Recapture. ICSC membership believes that the tax rate for straight-line real property depreciation recapture should not be changed. The current policy truly represents the economic reality of a commercial real estate investment. At present, the portion of gain attributable to prior straight-line depreciation deductions is taxed as long-term capital gain, at a special rate of

25%. Accelerated depreciation (amounts depreciated faster than straight-line) is recaptured at ordinary income rates. The current 25% capital gain rate for straight-line depreciation recapture recognizes the hybrid nature of real estate gains, which can derive from a combination of factors including general asset appreciation, inflation, and the value of the owner's improvements to the property. Raising depreciation recapture rates on real property from 25% to ordinary income tax rates would, depending on the top ordinary income tax rate, have a significant adverse effect on our industry, and would run counter to good tax policy.

Congress has recognized that gain on real property does not generally represent excessive depreciation deductions. Historically, depreciation recapture has been taxed at long-term capital gain rates.[1] In 1962, Congress enacted section 1245 of the tax code, which allowed for ordinary income treatment of depreciation recapture on personal property. However, the 1962 legislation did not extend the recapture rules to most depreciable real property, largely because of the concern that much of the gain in real property results from appreciation through external market conditions rather than as a consequence of excessive depreciation claims.[2] Consistent with this concern, in 1964 Congress adopted the first version of section 1250 of the tax code, which provides that only "additional depreciation" (the difference between the aggregate depreciation allowed to the taxpayer before the time of disposition and the aggregate depreciation that would have been allowable to the taxpayer over the same period under the straight line method of depreciation) is subject to recapture. Congress limited the recapture of depreciation to additional depreciation because of the probability that any excess gain is related to inflation or changes in market conditions.[3] Congress also believed that the portion of the gain that represented an inflationary rise in price levels was comparable to other forms of gain that are generally treated as capital gains, and thus should not be subject to recapture.[4]

As Congress acknowledged, the gain on the sale of real property may have no logical relationship to the amount of excessive depreciation. Further, taxation of all depreciation recapture at ordinary income rates could result in the taxation of inflationary gain. To the extent the taxpayer has held property for longer than a few years, much of the gain on the sale of such property could be due to

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[1] *See* Kahn, Douglas, "Accelerated Depreciation – Tax Expenditure or Proper Allowance for Measuring Net Income?" Mich. L. Rev. 78 (1979): 1-58. Before the Revenue Act of 1962 was adopted, a gain or loss recognized on the sale or exchange of depreciable property that had been used in a trade or business for a significant period of time was characterized as a gain or loss under Section 1231 of the tax code.

[2] S. Rep. No. 1447, 88th Cong., 2d Sess. 132 (1964); H.R. Rep. No. 749, 88th Cong., 1st Sess. 101-02 (1963).

[3] As stated in the Senate and House reports accompanying the 1964 legislation, Congress "believes that only to this extent could the depreciation taken appropriately be considered in excess of the decline in the value of the property which occurs over time. If a gain still occurs, it is believed that this is attributable to a rise in price levels generally rather than to an absence of a decline in the value of the property." S. Rep. No. 830, 88th Cong., 2d Sess. 133 (1964); H.R. Rep. No. 749, 88th Cong. 1st Sess. 10203 (1963).

[4] Id.

inflation. Taxing inflationary gain effectively represents a tax on capital, and it is particularly inappropriate to impose ordinary income tax on such gain. Capital gain treatment reduces the tax rate on inflationary gains, while the proposed changes to the depreciation recapture rules would contravene this policy.

The Cost Recovery Proposal would disavow the tax policy determinations discussed above and would increase the rate on straight-line depreciation recapture by over 58%. This major increase to a significant share of the taxable gain on a sale of real estate would dramatically alter the after-tax economics of real estate investments and would deter new investments by materially lowering the after-tax return for investors.

To summarize, retail real estate assets are typically held for a significant period of time and by subjecting all depreciation recapture to tax at ordinary income tax rates, the reform proposals would be far more likely to tax appreciation over time, inflation, and other market gains than capture excessive depreciation.[5] The current approach taken by section 1250 of the tax code – subjecting only "additional depreciation" to recapture at ordinary income tax rates – balances the goal of recapturing excessive depreciation with the reality that most gain on the sale of real estate is in no way related to prior depreciation deductions.

Section 1031 Like-Kind Exchange Rules. The section 1031 tax-deferral policy is premised on the understanding that in the event of a like-kind exchange, the taxpayer continues with an equivalent qualifying investment, with no intervening receipt of cash, and is left in the same tax position as if it kept the original asset. Section 1031 promotes the efficient use of productive capital and cash flow by allowing taxpayers to shift to more productive like-kind property, change geographic location, diversify or consolidate holdings, or otherwise transition to meet changes in business needs. Section 1031 does not reduce a taxpayer's tax liability; rather, it provides only a temporary tax deferral and does not eliminate the inherent taxable gain. The taxpayer also forgoes future depreciation deductions as the new property receives the same tax basis as in the original property. Taxpayers ultimately recognize their taxable gain when they "cash out" of the asset, and therefore have resources available to pay the taxes.

The section 1031 tax-free like-kind exchange rules are a critical component in the efficient deployment of capital, in significant part because they enable retail real estate owners to provide economic development in a restricted capital market. For decades, section 1031 of the tax code has enabled individual investors and businesses of all sizes to utilize their capital more efficiently by deferring the capital gains and depreciation recapture taxes on sales of certain assets that from an economic perspective are not sold, but rather are replaced via an exchange with property that is considered "like-kind" under the tax code. Like-kind exchanges are particularly critical to the efficient functioning of the large and highly illiquid market for shopping centers. According to our member survey, almost

[5] *See* Kahn, *supra* n. 1, at 48.

80% of our members utilize like-kind exchanges and many report that they are an integral part of the operations of their real estate-related businesses.

By deferring tax, real estate owners can efficiently transfer property among each other. This allows property to be placed with the person(s) who are best poised to ensure the property is put to its best use. By helping to get property into the right hands, the like-kind exchange rules facilitate job-creating property upgrades and improvements. Conversely, repealing like-kind exchange rules would reduce investment and depress real estate activity.

The Cost Recovery Proposal specifically asked for comments on whether the rules should be revised to require a "similar use" concept (such as in the Section 1033 involuntary conversion rules) in place of the "like-kind" concept. ICSC does not believe that the long-standing "like-kind" standard should be changed to the "similar use" concept that is currently an option for section 1033 involuntary conversion replacement property. The exclusive use of the similar use concept for real estate would soundly defeat the utilities of section 1031 because of the narrow definition of "similar use" as it applies to real estate.[6] Further, section 1033(g) currently recognizes this limitation with respect to real estate and makes the section 1031 "like kind" test also available for involuntary conversions of real property held for productive use in trade or business or for investment. Finally, a similar use concept would serve to create significant further complications to the tax code: 1) "similar use" requires the application of a set of rules that is much less settled than the "like kind" rules; and 2) is inherently complex due to the "functional use" concept that underlies it.

Lengthening real property depreciation lives. The Cost Recovery Proposal includes a lengthening of depreciation lives on all real estate to 43 years, which would apply to taxable years after December 31, 2014. This would result in an immediate lengthening of depreciation lives for non-residential property by over 10%, for residential property by over 56%, and for leasehold improvements by over 186%. What is arguably even more disturbing is that the changes apply to taxpayers owning property already placed in service, which gives the taxpayer no ability to adapt or lessen the sizeable economic impact accompanying such changes.

For several years ICSC has advocated for depreciation schedules that are more in line with market practices for replacing certain building components such as roofs and for updating retail space to reflect consumers' expectations and government regulations. We strongly believe that depreciation schedules should more closely reflect market practices than they have in the past.

Under current law, investments in real property – buildings, structures, and improvements – economically depreciate more rapidly than they are depreciated for tax purposes. In particular, the

[6] *See e.g.,* Reg. §1.1033(a)-2(c) (9)(i) (unimproved real estate is not "similar use" to improved real estate); Rev. Rul. 76-319 (an operator did not have "similar use" to replace bowling alley with billiard hall); and PLR 9723032 (motel is not similar use to apartment building).

effect of obsolescence is critical when measuring the rate of economic depreciation.[7] The mismatch between the tax and economic lives of real estate was recognized in a Treasury Department study on depreciation recovery periods, which concluded that a 30-year straight-line depreciation schedule for nonresidential real property would mirror the actual economic rate of depreciation.[8] However, the Cost Recovery Proposal does not decrease depreciation lives for real estate - - in fact, it would increase the disparity between the tax and economic lives of real property by extending the depreciation lives of real property to 43 years.

It is ICSC's position that the fifteen-year qualified leasehold improvement depreciation should not be repealed but instead should be made a permanent feature of the tax code, which would provide the industry with the stability and predictability needed to encourage capital improvements. Qualified leasehold improvement depreciation enables owners to deduct the cost of the customized improvements a building owner makes to a rental space to configure it for a tenant's needs over fifteen years. Absent this rule, such improvements would be depreciated over 39 years (43 years under the Cost Recovery Proposal). Clearly, leasehold and tenant improvements only survive for a fraction of a 39 (or 43) year period. Instead, such improvements typically last only for the average length of a lease term (often 5 to 10 years and rarely over 20 years). Thus, the current 15-year depreciation period more closely and accurately reflects economic reality. Longer depreciation periods would result in higher capital costs for building owners, creating disincentives to upgrade and modernize the space for their tenants. NAIOP has reported that the detrimental impact of this could be material: in 2011, leasehold improvement outlays of more than $15.5 billion added nearly $45 billion to the U.S. economy, and supported nearly 342,000 jobs.[9]

Maintain deduction for advertising costs. ICSC believes that requiring capitalization of 50% of advertising costs would unnecessarily complicate the tax code and discourage commerce. Advertising helps buyers and sellers connect and it serves the immediate need of shopping centers/retailers to attract customers. The vast majority of the benefits of advertising are immediate.[10] Deferring 50% of the tax deductions for advertising over 5 years would create a mismatch between tax and economics that would not only be bad from a policy perspective, but also would greatly disadvantage retailers and many other businesses. Further, the Cost Recovery Proposal would create an additional complication for taxpayers, who would need to determine what expenses are subject to capitalization and the related separate tracking of those expenses. Finally, this proposal disproportionately penalizes the

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[7] *See* Andrew E. Baum, "Quality, Depreciation, and Property Performance", The Journal of Real Estate Research (Fall 1993).

[8] Clinton Admin. Treasury Depreciation Study, at 89 ("Assuming straight-line depreciation, a 30-year recovery period would give nonresidential structures about the same marginal effective tax rate as implied by estimates of economic depreciation.").

[9] Statistics based on the April 12, 2013 NAIOP comment letter.

[10] *See* FASB Statement of Position 93-7 Reporting on Advertising Costs (December 29, 1993) (requiring expensing all but a small number of advertising costs which provide probable future benefits).

formation of new small businesses, which need visibility through advertising to survive. To summarize, this proposal creates unnecessary complication, harms small and new businesses, and hurts the economy overall by discouraging the needed connection between consumers and retailers.

Revamp energy-efficient building incentives. While we understand the limitations of the existing Section 179D for building efficiency, instead of a simple repeal, Section 179D should be revised with new rules that are more effective in encouraging the energy efficiency of buildings. For example, legislation has been introduced that would make improvements to section 179D, including providing for a sliding scale that would increase the amount of the incentive for retrofits with greater energy savings. Improvements to section 179D would encourage ambitious energy efficiency projects while also rewarding projects that achieve meaningful yet more moderate levels of energy savings. Further, a June 2011 report from the Political Economy Research Institute at the University of Massachusetts – Amherst found that section 179D with modifications to encourage building retrofits would create 77,000 new jobs in the first two years after enactment.

Impact on small businesses

ICSC believes that the proposed reforms discussed above will result in tax increases for many small retail real estate businesses, the profits of which are mostly taxed at individual rates. Reforms that are biased against the real estate industry— a reverse of the type of stimulus usually used to encourage capital investment—could push the economy backwards. As stated previously, because much of the real estate industry operates through pass-through entities, the net effect is that real estate and many if not most small businesses, would bear a disproportionate share of the costs while not receiving the benefit in terms of lower tax rates.[11] These concerns are compounded by the recent increases in marginal tax rates for individuals, who make up a disproportionately large portion of real estate developers and investors who are not otherwise tax exempt.

Conclusion

Tax reform has complex and far reaching economic effects and the reform process needs to allow taxpayers to fully react and adjust to new rules. Similarly, economic structures currently in place would not be able to realign quickly to take into account changes. Therefore ICSC believes that it is imperative that changes only be prospective such that property already under contract to build or property already placed in service would be grandfathered. Finally, the legislative process of asking taxpayers to react to piecemeal, single revenue raisers without seeing the full comprehensive plan does not allow taxpayers to fully assess the changes in a meaningful way. The potential effect on the real estate industry from combining various proposals has created genuine trepidation among ICSC's

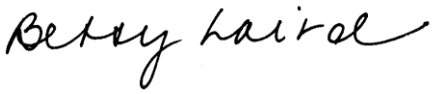
[11] We appreciate that this concern was noted in the SFC Discussion Draft Summary where it stated that "As part of this effort, however, the larger business community needs to be considered since passthrough businesses will not benefit from a corporate tax rate reduction but could suffer increased tax burdens from broadening the business tax base." U.S. Senate Committee on Finance, Summary of Staff Discussion Draft: Cost Recovery and Accounting (11/21/2013), at 2.

membership. For instance, an increase to depreciation recapture rates alone would be detrimental to the retail real estate industry, but combining this change with other proposed modifications of the tax code, such as eliminating section 1031 exchanges, would be viewed as disastrous.

We have included an example in the Appendix. Taking into account the various risks to be undertaken with a new project, the consequences of the Cost Recovery Proposals raise significant, if not compelling, reasons that will deter developer motivation to take on such risks, depressing the revitalization of obsolete assets around the country, as well as reducing capital investment and the significant job creation associated with retail real estate and the commercial real estate industry as a whole.

Once again, thank you for your careful deliberation of the potential impact of tax reform on the retail real estate industry, and we look forward to working with you as the process to reform the tax code moves forward.

Sincerely,



Betsy Laird
Senior Vice President, Global Public Policy
International Council of Shopping Centers

Appendix Example

The example below demonstrates how multiple provisions of the Cost Recovery Proposal could negatively affect a single taxpayer.

Facts. Shopping center developer ("Developer") owns Centers 1 – 4. Developer has held Center 1 for 20 years and Developer would like to exchange it, with additional investment, for Center 5. Centers 2 and 3 are stabilized and producing after-tax cash flow just sufficient to service their mortgage debt and cover debt covenants. They have 30 years left on their building depreciation and 6 years left on their leasehold improvements amortization. Center 4 is a prospective project that Developer is considering, but Developer's business decisions regarding whether to enter into the investment are impacted by the Cost Recovery Proposal.

Center 1 – Effect of elimination of section 1031 and ordinary income tax rates on depreciation recapture.

Section 1031. The elimination of section 1031 would require significantly more cash for Developer to move from Center 1 to Center 5. As a small business that doesn't have access to the public markets for cash, Developer is unlikely to have the liquidity to pay the income taxes otherwise due on a sale. Even if the property is sold for original cost, there would be significant taxable income because approximately 50% of the original cost will be taxable from the prior tax depreciation. Further, capital gains taxes are due on any "appreciation" in the property, which after 20 years is largely comprised of a change in nominal values from inflation.

Depreciation recapture rates. Raising depreciation recapture rates on real property from 25% to ordinary income tax rates (currently 39.6% top marginal rates), would compound the costs of the Cost Recovery Proposal's elimination of section 1031 rollovers. As a 20-year old property, the recapture is equal to approximately 50% of the original costs, and is likely to be a significant number. Raising rates by 14.6 percentage points from 25% to 39.6% represents a 58.4% tax increase on this taxable gain.

Quantification. Developer acquired Center 1 for $5M twenty years earlier. Prior depreciation is $2.5M so tax basis is $2.5M. The current value of Center 1 is $15M (largely due to inflation). Developer wishes to rollover all $15M of proceeds into new Center 5, but if both section 1031 and depreciation recapture proposals were adopted, Developer would owe $2.99M of federal taxes, plus state taxes, leaving a material shortfall in Developer's ability to fund the acquisition of Center 5.

Centers 2 & 3 – Effect of change in depreciation lives.

Change in depreciation lives. The immediate effect of changes in depreciation lives is most apparent in existing shopping centers like Center 2 and 3, which also have unamortized leasehold improvement costs. After applying the new rules to property already placed in service, existing cash flows that had already been used as a basis for business decisions and in determining cash flows would have changed.

As tax is an important part of the calculation of whether a real estate deal is economically feasible, this has the potential to put existing shopping centers at economic risk.

Quantification. Between Centers 2 and 3, Developer has $6 million in leasehold improvements to depreciate over the remaining 6 years ($1 million/year). Developer also has $30 million in other depreciable tax basis to recover over 30 years ($1 million/year). The proposed change would result in the remaining $6 million of leasehold improvements to be depreciated over 34 years (43 years less 9 years previously elapsed). Thus the annual depreciation for the next 6 years decreases from $1 million to $176,471, a decrease of over 82% per year. Further, the $30 million general tax basis is now depreciable over 34 years instead of the previously 30 years (43 less 9 years previously elapsed). Thus the depreciation per year has decreased from $1 million a year to $882,353, a decrease of almost 12% per year.

Center 4 – Cumulative effect of Cost Recovery Proposal on decision for new investment.

Developer is considering purchasing a underperforming property in an emerging neighborhood and rehabilitating it. Most developers are unwilling to enter into such neighborhoods, but Developer has experience, key relationships with retailers willing to serve underserved neighborhoods, and relying on existing tax laws. Developer's business model involves using significant leasehold improvements to entice otherwise hesitant tenants and, once a project is stabilized and repositioned, using section 1031 as a tax-efficient means to move the capital investment into new properties in need of redevelopment. In light of the Cost Recovery Proposal, Developer decides to cut back on one-third of new projects in the most at-risk areas because it is simply uneconomical on an after-tax basis as result of (1) a 186% longer depreciation period for leasehold improvements, (2) losing the tax-deferral of section 1031 when exiting the investment, and (3) having a much higher tax rate on a taxable exit by taxing straight-line depreciation recapture as ordinary income. Consequently, those investments simply do not "pencil out".