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## ***How True Tax Reform Would Eliminate Breaks for Real Estate Investors Like Donald Trump***

The federal tax code includes several loopholes and special breaks that advantage wealthy real estate investors like President Donald Trump. Under current law, real estate investors can claim losses much more quickly and easily than other taxpayers, but they also have several methods to delay or avoid reporting any profits to the IRS. They can run up debts that they fail to pay with fewer tax consequences than other investors, which Trump took advantage of when he was unable to pay his debts on his Taj Mahal casino and other endeavors. A special rule even ensures that they save on taxes when they take depreciation deductions for their property, which is premised on the idea that it is losing value, even though the property's value often rises and it is sold at a profit.

In 1995, Donald Trump pushed some of these special breaks and loopholes to extremes to report losses of \$916 million, which he likely carried forward to avoid paying personal income taxes for several years. In 2004 Congress closed one of the loopholes he used.<sup>1</sup>

This report explains how Congress can close the remaining breaks that Trump used and several others that large-scale real estate developers like him typically enjoy.

The tax breaks for wealthy real estate investors fall into four broad categories.

**First, real estate investors can use losses more easily than other taxpayers to reduce their tax bills.** Donald Trump likely never invested \$916 million of his own money. Investors in other types of business are subject to stricter rules barring them from claiming losses that exceed what they really invested — what they have “at risk.” But real estate is subject to looser rules to determine what constitutes “at risk” or a “passive loss.”

**Second, real estate investors can defer reporting capital gains and other income more easily than other taxpayers can.** Usually whenever an asset is sold at a profit, that profit is a capital gain subject to income tax. But wealthy investors who can afford sophisticated tax planning can arrange instead to trade an appreciated property for another property, and avoid reporting income to the IRS because, technically, no sale occurred. These “like-kind” exchanges are just one of the methods that are available to major real estate investors to defer reporting profits. The bills before the House and Senate eliminate like-kind exchanges — except for real estate.

**Third, real estate investors can more easily avoid reporting debt forgiveness as income.** As a general rule, forgiveness of debt is considered income that is subject to income tax. Without such a rule, the income tax would be very easy to avoid. For example, workers could ask their employers to change their compensation to loans that are later forgiven, so that their compensation would not be subject to income tax. Business owners could avoid income taxes on

gains when they sell part of their company by exchanging equity for debt forgiveness instead of cash. This would provide an even greater tax benefit if the business owner is allowed to take deductions for interest on the debt.

But major real estate investors *can* achieve these results because the rules for debt forgiveness are less strict for them. Donald Trump even used a loophole allowing him to claim deductions for interest payments that he *never actually made*.

**Fourth, real estate investors benefit from depreciation deductions when the value of their property is actually climbing.** Owners of assets are allowed to claim deductions for depreciation, which is supposed to reflect the fact that assets wear out and lose their value over time. Investors in real estate are allowed to depreciate buildings they own even though they sometimes then sell them at a profit, reflecting the fact that their value actually increased rather than fell.

The benefit of this would be limited to a degree if the rules ensured that profits reflecting amounts already depreciated were taxed at “ordinary” income tax rates rather than a special, low capital gains tax rate, as is the case today. The current rules allow, for example, a high-income taxpayer to save 39.6 percent of an amount deducted for depreciation on a building but then pay just 25 percent of that same amount when the building is sold at a profit. This provides an unjustified subsidy for extremely high-income individuals who invest in real estate.

The bill before the Senate actually expands this benefit by allowing real estate investors to depreciate property over a shorter time period, meaning they receive tax deductions sooner than under current law.

### ***Options for Reform:***

#### ***1) Repeal breaks allowing real estate losses to be claimed more easily than other types of losses.***

The true profitability of a business is measured over the course of several years rather than in one year alone. Some business decisions are made with the expectation that an investment will lose money for a couple of years before generating a profit so that over the course of several years the investment will provide a net profit. This is true, for example, of start-ups that may have losses for a few years before generating profits.

Companies and business people are therefore allowed to carry excess losses into the future and deduct them against future profits, and the result is that the net profits of the business over the long-term are taxed. But Congress has also enacted safeguards to ensure that taxpayers do not abuse the rules and use losses that exist only on paper to shield their real income from taxes. Because of intense lobbying from the real estate industry, these safeguards do not apply nearly as strictly to large-scale real estate investment as they do to other types of investment. Congress should take the following steps to remedy this.

#### ***Repeal special at-risk rules for real estate under section 465.***

The general rule is that a taxpayer cannot take losses that exceed the amount she has “at-risk” in the business, which can be thought of as “skin in the game.” Amounts considered “at-risk” can include money the taxpayer invested, or amounts that she borrowed if she is personally liable for the loan or has secured the loan with property *other than* the property purchased with the loan. In other words, the amount that is “at-risk” usually excludes any “nonrecourse loan,” which is a

loan for which the borrower is not personally liable and the only collateral is the property purchased and used in the enterprise that is being financed.

However, a special rule under sec. 465(b)(6) of the tax code considers amounts owed on a non-recourse loan used in a business to be “at-risk” if the collateral is real estate. This means that an individual can claim losses from a real estate project even though he invested none of his own money and is not personally liable for any borrowed amounts that were invested. Congress should repeal sec. 465(b)(6).

### ***Repeal special passive loss rules for real estate under section 469.***

A general rule distinguishes the income or losses that are “passive,” which means they come from an activity that the taxpayer is not actively involved in. For example, a taxpayer who owns a restaurant and works full-time in the kitchen and manages the business will have business income that is *not* passive. The employees she pays to work there will also have income that is *not* passive. However, imagine that she allowed her brother to invest some money to obtain a piece of the business. If he did no other work for the business, any income that he received would be passive.

If the restaurant spends more than it makes in a particular year, his losses will be passive. The tax rules bar him from using his passive losses to offset income that is not passive. These rules were enacted in 1986 because wealthy taxpayers were purposely investing in businesses that would appear to generate losses, which they would use to offset their other income for tax purposes.

Income and losses from a rental business are inherently passive. Rental income is not generated from work but from the asset being rented. The passive loss rules therefore specifically define passive activity to include rental activities.

However, section 469(c)(7) was added to the code in 1993 in response to intense lobbying to create an exception for rental of real estate by any “real estate professional,” which is defined as someone who spends over 750 hours a year providing services related to real estate. The services are not even limited to renting real estate, but include developing, constructing and managing real estate.

Congress should repeal sec. 469(c)(7) so that renting real estate will be treated just like renting other types of property. This means that losses from real estate would not be used to offset other types of income for tax purposes.

## ***2) Repeal breaks allowing real estate investors to put off and avoid paying taxes on profits.***

### ***Sharply limit like-kind exchanges under section 1031.***

The profit received when one sells a property for more than its purchase price is a capital gain that is usually reported as income and taxed. But section 1031 of the tax code allows a taxpayer to trade a property for another that is, in theory, a similar property without recognizing any gain and thus putting off paying income tax on that gain. This is a so-called “like-kind exchange.” Whereas most working people must pay income taxes on their income each year, large-scale real estate investors can put off paying income taxes on capital gains (which may be their main source of income) for years by trading appreciated properties rather than selling them. If an investor leaves such properties to his or her heirs, the capital gains are never taxed (because the heirs receive a “stepped up” basis).

Like-kind exchanges were originally intended for situations in which two farmers trade land or livestock. If, for example, livestock is exchanged but no money changes hands, it may have seemed reasonable to waive the rules that would normally define this as a sale and tax any gains from it. This was a minor accommodation in the tax code that also made the rules easier to administer.

But this tax break has turned into a multi-billion-dollar loophole that is now used primarily by corporations rather than individuals. The term “like-kind” has been stretched beyond all recognition. For example, in one case a trade of Midwestern farmland for a Florida apartment was considered a like-kind exchange.<sup>2</sup>

These exchanges are not the arrangements between farmers one might imagine. Investors who want to sell property to willing buyers with cash use brokers who find property from another party that qualifies as “like-kind” to insert into the deal.

The bills before the House and Senate eliminate like-kind exchanges for all types of property except real estate.

Congress should eliminate like-kind exchanges or at least limit the gain excluded under section 1031 to \$1 million.

***Repeal special rules for installment sales of timeshares and residential lots under section 453A(b)(4), 453(l)(2)(B) and 453(l)(3).***

When the payment from a sale of property reflects capital gain and is made over several years, the code allows the taxpayer receiving the payments to report the gains in separate installments each year, rather than report the total in the year in which the sale is made. Because this provides what is essentially a loan from the IRS, taxpayers with a large volume of installment sales must pay interest on the amount of tax they defer by using this method. (Interest is charged only if the taxpayer’s installment sales for the year exceed \$5 million, excluding any individual sales for less than \$150,000.)

However, a special rule allows a more generous interest charge for installment sales if they involve timeshares and residential lots. Congress should repeal section 453A(b)(4) and sections 453(l)(2) and (3).

***Repeal the exception to the percentage-of-completion method for home construction contracts under section 460(e).***

Usually a taxpayer who produces property under a long-term contract is required to use the percentage-of-completion method to determine how much income to report from the contract each year. This means that the taxpayer reports as income a percentage of the contract price equal to the percentage of the contract completed each year. There is an exception to this rule for certain home construction contracts, which may use the completed-contract method, which simply means that the taxpayer reports no income from the contract until it is completed.

One problem is that some real estate developers argue that a contract is not “completed” until an entire planned community, including amenities that have nothing to do with housing, are also completed. The U.S. Court of Appeals for the Ninth Circuit recently upheld a Tax Court decision allowing a developer named Shea Homes to defer taxes on about \$900 million in profits using this argument.<sup>3</sup>

Congress should repeal the home construction exception to the percentage-of-completion method under section 460(e).

### **3) Repeal breaks allowing real estate investors to receive income in the form of debt cancellation without paying income taxes.**

As a general rule, forgiveness of debt is considered income that is subject to income tax. Without such a rule, the income tax would be very easy to avoid. For example, workers could ask their employers to change their compensation to loans that are later forgiven, so that their compensation would not be subject to income tax. Business owners could avoid income taxes on gains when they sell part of their company by exchanging equity for debt forgiveness instead of cash. This would provide an even greater tax benefit if the business owner is allowed to take deductions for interest on the debt.

The rules that treat cancellation of debt as income for tax purposes are meant to prevent this type of tax avoidance. But these rules are less strict for large-scale investors in real estate.

It appears that Donald Trump was able to avoid reporting income from hundreds of millions of dollars of cancellation of debt in the 1990s related to his real estate ventures. He started with a particularly aggressive tax avoidance technique involving swapping equity for debt (which Congress would eventually eliminate in 2004) and claimed a version of it that was not supported by the law.<sup>4</sup> Several other loopholes related to debt cancellation remain.

#### ***Repeal special treatment of discharge of indebtedness under section 108.***

Section 108 of the tax code allows taxpayers in certain difficult situations, such as taxpayers in bankruptcy or insolvency, to receive income in the form of cancellation of debt without including it as income for tax purposes. The idea is that the economic position of the taxpayer has not really changed. But the taxpayer must pay for this benefit in the future by reducing loss carryforwards, tax credits, or other breaks that would otherwise benefit the taxpayer.

Section 108 extends this generous treatment of debt cancellation to real property that is used in a business regardless of whether or not the taxpayer is in bankruptcy or is insolvent. As a result, the rules are more lenient for debt related to real property than for other types of debt, even though the taxpayer must pay for this benefit by reducing of basis in depreciable real property.

Congress should repeal the special rules for debt related to real estate in sections 108(a)(1)(D) and 108(c).

#### ***Clarify that REMICs should be treated like other entities for purposes of debt cancellation under section 860A.***

Real estate mortgage investment conduits (REMICs) are entities created to hold real estate mortgages. The section creating them, 860A, ensures that REMICs themselves are not taxed but the income generated from the mortgages they hold is passed through to the investors and taxed under the personal income tax (like profits generated by a partnership).

Section 860A says REMICs are not to be treated like a corporation, partnership or trust, which may be interpreted to mean that certain related-party rules concerning discharge of indebtedness (under sections 108, 707, and 267) do not apply.<sup>5</sup> Under these rules, a debt acquired by a party related to the debtor is treated as acquired by the debtor himself, meaning the debtor has income in the form of debt forgiveness.

These rules prevent a debtor from arranging to have a related party (for example, a family member of the debtor or a business that the debtor owns) acquire the debt and implicitly agree to not demand payment of the debt. Without these rules, the debtor in that situation could claim to not have debt forgiveness even though the related party now holding the debt will clearly not demand payment of it.

Section 860A could be interpreted to mean that these rules do not apply to REMICs. As a result, a large-scale real estate investor might create a REMIC to hold mortgages related to his business and know that the REMIC will never require him to pay the debts even while he claims to the IRS that his debts have not been discharged for income tax purposes.

Congress should prevent this by amending section 860A to clarify that sections 108, 707, and 267 apply to REMICs as they do to other entities.

***Amend section 461 to bar deductions for interest payments by taxpayers who are not actually making payments on a loan.***

When an investment is debt-financed, the taxpayer is allowed to deduct the interest payments as a business expense. The interest payment is taxed as income to the lender receiving it. A loophole allows some taxpayers to take interest deductions even when no interest is actually paid and no lender is taxed on it.

Most large businesses are “accrual” taxpayers, meaning they deduct payments when they are obligated to make them, regardless of when they actually are made, and report payments they are entitled to receive as income, regardless of when they will actually receive them.

But some of the interest payments that Donald Trump deducted as an accrual taxpayer were never paid at all. He never actually paid the cash to his lenders (who were public bondholders). He appears to have deducted \$189 million for interest that he did not actually pay, on debt related to the Taj Mahal casino in Atlantic City.<sup>6</sup> The lenders likely avoided reporting the interest as income under a doctrine called “doubtful collectability” which would have applied to debt of an investor with the financial problems Trump had at that time.

While not strictly limited to real estate, this loophole would be particularly useful to a “pass-through” business such as Trump’s casino business, which can pass deductions onto their owners to be used even when the business is operating at a loss.

Congress should enact a rule that a taxpayer who has missed a payment on a loan will not be allowed to deduct additional interest on that loan until she is caught up on payments.

***4) Repeal breaks making it easier to take depreciation deductions premised on declining value of property even when the property is sold at a profit.***

***Repeal special treatment of real estate in depreciation recapture rules under sections 1250 and 1(h)(1)(d).***

When property is purchased and rented out, the tax rules assume that any buildings on the property wear out over time and therefore allow the taxpayer to deduct the cost of these buildings over time. (Land is not depreciated because it does not wear out.) Buildings on rental property are depreciated over 27 ½ years in the case of residential real estate and 39 years in the case of commercial property. But these rules do not necessarily track economic reality. For example, the

owner of a rental property can take depreciation deductions (which, again, are premised on the idea that the buildings are wearing out) even when the property value is rising. There is no way to directly fix this problem because it would be difficult for federal tax rules to closely track the actual value of each property each year. (Appraisals of property are done only at the state and local level and they vary dramatically from one jurisdiction to another.)

For most types of property, the benefit of depreciating and then selling a property at a profit is limited to a degree by “depreciation recapture” rules. These rules require that any gain attributable to the amount depreciated must be included as ordinary income when the property is sold and therefore subject to ordinary income tax rates. For example, imagine that you buy an asset for \$100,000 and over several years take depreciation deductions of \$50,000, which is based on the assumption that this particular type of asset would lose half its value over this period. Then you sell the property for \$160,000, which means the property clearly gained, rather than lost, value. In this situation, you would report \$110,000 gain of which \$60,000 would be capital gain and \$50,000 ordinary income. The \$50,000 is the amount that was deducted through depreciation and that is “recaptured” by these rules.

Often the gain on the sale of an asset is a long-term capital gain that would normally be subject to lower income tax rates (with a top rate of 20 percent). But for the depreciation recapture rules to truly work, they must tax the recaptured amount at “ordinary” income tax rates (with a top rate of 39.6 percent) if the deductions that are being recaptured were themselves taken against income that was taxed at ordinary rates. Otherwise those who depreciate an asset and sell it at a profit would receive a subsidy from the tax rules that has no policy rationale. For this reason, the depreciation recapture rules do require that, for most types of property, the recaptured amount is taxed at ordinary rates if the deductions were taken against ordinary income.

But a special rule under section 1250 of the tax code ensures that depreciation for almost all real estate is never recaptured as ordinary income, but instead as capital gains subject to a special tax rate of 25 percent. For wealthy investors in any income tax bracket above the 25 percent bracket, this provides tax savings that have no clear justification.

Congress should repeal the special rules under sections 1250 and 1(h)(1)(d) and thus apply to real estate the same recapture rules that are used for other property.

The bill before the Senate expands this unjustified subsidy by allowing residential and commercial buildings to be depreciated over 25 years rather than the 27 ½ years and 39 years required respectively, under current law.

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<sup>1</sup> Steven M. Rosenthal, “Protecting Trump’s \$916 Million of NOLs,” *Tax Notes*, November 3, 2016. <http://www.taxanalysts.org/content/protecting-trumps-916-million-nols>

<sup>2</sup> Gregg Eisenwein, “The Sale of a Principal Residence Acquired Through a Like-Kind Exchange,” 2005, Congressional Research Service. <http://congressionalresearch.com/RS22113/document.php?study=The+Sale+of+a+rincipal+Residence+Acquired+Through+a+Like-Kind+Exchange>

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<sup>3</sup> *Shea Homes, Inc. and Subsidiaries ET AL., v. Commissioner, Nos. 14-72161, 14-72162, 14-72163 (2014)*.  
<https://www.ustaxcourt.gov/InOpHistoric/SheaHomesDiv.Wherry.TC.WPD.pdf>

<sup>4</sup> Rosenthal, *supra* note 2.

<sup>5</sup> Robert J. Lord, "Is Trump's \$915 Million Tax Loss Connected to an Exotic Tax Shelter?" Emptywheel, October 4, 2016.  
<https://www.emptywheel.net/2016/10/04/trump-tax-loss-exotic-shelter/>

<sup>6</sup> Rosenthal, *supra* note 2.