



# THE AMERICAN INSTITUTE OF ARCHITECTS

## COMMENTS ON TAX REFORM

### Senate Finance Committee

April 15, 2015

#### Introduction

The AIA, the leading professional membership association for architects since 1857, strongly supports comprehensive tax reform that lowers marginal tax rates for individuals, pass-through entities, and corporations, while broadening the tax base and simplifying the tax code.

We recognize that tax reform is a balancing act. Lowering tax rates will require curtailing or discarding many tax expenditures, while maintaining and improving a limited number of tax policies that support important policy objectives. That said, tax reform is an opportunity to provide taxpayers with much-needed certainty, simplicity, and fairness, while at the same time encouraging economic growth and job creation.

Our strong hope is that tax reform results in simple, commonsense tax policies for businesses of all sizes, aimed to spur innovative, economically vibrant, sustainable, and resilient buildings and communities. As the Committee and Congress consider tax reform, we urge consideration of the following principles:

- Preserve tax policies that support and strengthen small businesses, which account for the vast majority of U.S. architecture firms;
- Consider tax policies that support economically vibrant, innovative, sus-

tainable, and resilient buildings and communities; and

- Ensure fairness in the tax code.

This statement discusses these issues in more detail: (1) policies that support a vibrant built environment, particularly IRC Section 47 and IRC Section 179D; (2) small business issues, such as cash accounting; and (3) policies aimed at increasing international competitiveness, such as IRC Section 199, the domestic production activities deduction.

#### The American Institute of Architects

The AIA represents more than 86,000 architects, emerging professionals and allied partners nationwide and around the world.

In 2013 alone, the 18,000 architecture firms owned by AIA members grossed billings of \$31.1 billion,<sup>i</sup> driving economic activity and job growth in communities across America. Moreover, most architecture firms at which AIA members work are small businesses, with nearly 97 percent of firms having fewer than 50 employees.”

Architects work to advance the public’s quality of life through their commitment to healthy, safe, resilient and sustainable communities. From designing the next generation of energy-saving buildings to making our communities healthier

and more vibrant, to helping neighborhoods rebuild after disasters, to exporting American design know-how to the rest of the world, architects turn dreams and aspirations into reality.

## **Supporting a Vibrant Built Environment**

As tax reform progresses, it is important to consider tax policies that support innovative, economically vibrant, sustainable, and resilient buildings and communities. To that end, we want to highlight the need to continue and improve tax policies aimed at historic preservation and energy efficiency.

Among the most important incentives to the revitalization of communities throughout the country is the Historic Tax Credit (HTC). Weakening or eliminating the credit would endanger the economic feasibility of nearly all historic rehabilitation projects. Without the credits, the numbers simply do not work. Historic rehabilitation has a financing gap because rehabilitation is more expensive than new construction. Also, 84 percent of all transactions are located in low-income census tracts. Without the credits, these properties often sit idle often for decades, exerting a blighting influence on the surrounding neighborhood.

Research conducted for the National Park Service by the Rutgers Center for Urban Policy Research documents that since enactment of the historic tax credit in 1981, the credit has leveraged \$117 billion in private investment in historic rehabilitation, created nearly 2.5 million jobs and rehabilitated more than 40,000 historic buildings. The HTC is the most significant federal investment in historic preservation. It has also proven to be an efficient use of taxpayer dollars. Over the credit's 34 year history, the federal government has allocated just over \$24 billion in tax credits, but collected \$28.6 billion in federal tax revenue from rehabilitation projects – more than paying for the program. For every dollar of public expenditure, private investors contribute four dollars toward the rehabilitation of historic properties.

Rehabilitation projects across the country are putting Americans back to work. In a typical re-

habilitation project, 60–70 percent of the total cost is labor as compared to new construction where labor often accounts for less than 50 of the total cost. Laborers on a rehabilitation project are more likely to be hired locally, and they in turn spend into the local economy. Seventy-five percent of the economic ripple effect of a historic rehabilitation project is captured by the state and city where the property is located. It has been stated time and again that the vast majority of new jobs in the United States are created by small businesses. Rehabilitated historic buildings are ideally suited to support emerging small businesses that are often looking for a central location and main street appeal.

The historic tax credit is an important redevelopment tool that is helping revitalize cities and towns across America.

On energy efficiency, the AIA has been working with other design and construction, real estate, and energy efficiency industry stakeholders, who have submitted to the Senate Finance Committee a joint statement in support of IRC section 179D.

The Energy Efficient Commercial Building Deduction, which is contained in section 179D of the tax code, has been an extremely effective tool in increasing the energy efficiency of buildings. Section 179D has leveraged billions of dollars in private capital, resulting in the energy-efficient construction and renovation of thousands of buildings, while creating and preserving hundreds of thousands of jobs. It is one of the best examples of the tremendous impact tax incentives can have on financing energy-efficient property.

Section 179D's success demonstrates the strong need to retain an energy efficiency provision in the tax code in some form. In the case section 179D is retained close to its current form, we strongly urge Congress to make permanent and enhance the section 179D deduction by: (1) ensuring the ability of pass-through entities to capture the full value of an allocated deduction in the case of a public owner of a building; (2) allowing non-profit owners of buildings, similar to public owners of buildings, to allocate the deduction; and (3) increasing the value of the deduction.

### Allocating the Section 179D Deduction to a Pass-Through Entity.

Section 179D provides a federal, state, or local government owner of a commercial building an election to allocate the tax deduction to the primary person responsible for designing the energy-efficient enhancements. In December 2010, the Internal Revenue Service (IRS) released a memo that effectively prevents firms organized as partnerships or S corporations from fully realizing the benefit of an allocated section 179D deduction.<sup>ii</sup>

In order for partnerships and S corporations to obtain the intended benefits, it is necessary for partners and S corporation shareholders to obtain a basis in their partnerships and S corporations that is not reduced by an allocated section 179D deduction. This issue could be addressed by a simple statutory modification to expressly require the Department of Treasury to issue regulations that properly determine partnership or S corporation outside basis in the case where section 179D is allocated. Such a clarification would provide certainty and address a widespread concern among many small businesses that design energy-efficient buildings.

### Allocating the Section 179D Deduction in the Case of a Non-Profit Owner of a Building.

In many cases, non-profit entities, such as hospitals, universities, private schools, charities, and foundations, conduct functions similar to state and local governments. Currently, non-profit entities own thousands of properties across the country. Although retrofits to these properties could result in significant energy savings, the non-profit entities do not pay taxes and, consequently, cannot benefit from section 179D.

The section 179D allocation provision should be expanded to provide non-profit owners of buildings, similar to public owners of buildings, with the ability to elect to allocate the deduction to the primary designer of the building. Such a provision would assist non-profits in financing energy-efficient upgrades and would reduce their energy costs in the longer-term.

### Enhancing the Section 179D Deduction.

The maximum section 179D deduction of \$1.80 per square foot has not been increased since the deduction was put in place in 2005 and, as a result, has not kept pace with inflation. Consequently, the impact of section 179D has become diminished over time.

Increasing section 179D from the current maximum allowable amount of \$1.80 per square foot to \$3.00 per square foot would increase its effectiveness. In the case of individual subsystems, the maximum allowable deduction should be increased from \$0.60 per square foot to \$1.00 per square foot. Bipartisan legislation was introduced in the Senate in the 112<sup>th</sup> Congress to enhance the deduction in this way (S. 3591).

Enhancing section 179D would provide an important source of additional capital to stimulate building design, construction, and renovation, driving the creation of well-paying jobs. An enhanced 179D deduction would further incentivize energy efficiency, improve the nation's commercial building stock, and increase energy independence.

In its current form, the Internal Revenue Code (IRC) contains a number of important tax provisions that impact development generally. These include policies such as depreciation deductions (IRC § 168) and like kind exchanges (IRC § 1031). Each of these provisions provides important support for the design, construction, and renovation of buildings of different types. However, the complexity of the tax code, inconsistency in the requirements and metrics of differing provisions, and a lack of policy coordination between them often blunts their impact. As the AIA's 2010 study [Promoting Livable Communities](#) notes:

*There are hosts of tax policies that impact real estate generally. However, because there was no overarching federal vision for livability at the time of their development, the incentives tend to address single pieces of the larger picture and have a strong focus on individual buildings, making it difficult for communities and developers to use*

*the tax policies to create livable, sustainable patterns of development.*

Tax reform presents the opportunity to review these policies, identify important policy objectives, and develop and improve tax policies that empower building owners and their communities to achieve these objectives.

Of course, there are certain provisions that must be preserved in some form in order to maintain economic vitality. For example, decreasing depreciation deductions by significantly extending recovery periods increases the tax burden on owners and harms overall real estate investment. Likewise, eliminating or substantially changing the rules surrounding like kind exchanges would burden the real estate industry by slowing the recovering market and delaying design and construction improvements.

Instead of a piecemeal approach to reforming these provisions among others, we encourage the committee to view the built environment holistically, and re-envision tax policies that encourage new and existing property improvements benefiting the community and environment at large, on a macro level.

### **Preserving Small Business**

As Congress moves forward with tax reform, tax policies aimed at strengthening small businesses -- including tax policies that maintain the ability of businesses to choose pass-through forms of entities -- should be preserved.

The overwhelming majority of U.S. architecture firms are small businesses with fewer than 50 employees. A significant portion of these firms are organized as pass-through entities, including partnerships and S corporations.

It is imperative that tax reform is comprehensive, addressing tax issues for individuals, pass-through entities, and corporations. "Corporate-only" tax reform would leave pass-through entities at a severe disadvantage, harming small businesses, including architecture firms.

We also urge Congress to preserve tax policies that are aimed at strengthening small businesses,

reducing compliance burdens, and providing certainty. Such policies would help spur economic activity by helping small businesses expand operations and drive job creation by allowing small businesses to hire new workers and increase wages and benefits.

### Preserve Cash Accounting

One issue of particular importance to small businesses and personal service companies who rely on payments from clients to stay afloat is the cash accounting method. Presently, architecture firms are able to use cash accounting to pay taxes on income and payments at the time they are received. However, proposals in the Cost Recovery and Accounting discussion draft would force firms that make over \$10 million a year to use the accrual method of accounting.

Requiring these firms to use the accrual method would subject those who own and operate these businesses to immediate taxation on uncollected revenues. This would have severe and significant negative consequences on these businesses and their owners:

- It would result in an effective tax increase to the owners because they will be taxed on income that they have not received, without a concomitant increase in expenses.
- It will lead to significant cash-flow problems. For example, among professional services firms the primary cost is labor, and businesses must regularly pay their employees even if they are not paid by their clients for several months. The use of cash accounting helps to mitigate this challenge by matching the timing of tax liabilities with the collection of the income being taxed.
- Cash accounting is clear and straightforward, while accrual accounting adds complexity and opacity, increasing the burdens faced by these businesses and their owners and forcing them to commit even more scarce resources to compliance efforts.

- It will impair business growth and job creation by tying up funds otherwise available for expansion.

The cash to accrual proposal undermines the core principles of tax reform: facilitating growth, creating jobs, making US businesses more competitive, providing certainty and making the tax code more fair and simple. In fact, this proposal would burden relatively small businesses with complex changes in accounting practices, immediate tax increases, and unequal footing with similarly situated businesses that receive payment at the time of delivery of goods or services.

### **Ensuring International Competitiveness**

It is important that tax reform preserve and improve American businesses' international competitiveness. Many architecture firms engage with developing markets overseas -- so much so, in fact, that there is increasing pressure for these firms to move headquarters to more favorable tax jurisdictions abroad.

In this regard, a tax policy of significant interest to the architecture industry is the Domestic Production Activities Deduction contained in section 199 of the IRC.

Proposals have been offered to repeal or reform section 199. Proponents of such proposals assert that repealing section 199 could provide revenue to offset the cost of lower marginal tax rates. However, we urge that, if section 199 is retained in some form, that it be retained for currently-eligible trades and businesses, including architectural services.

By way of background, section 199 was designed as a replacement for previous U.S. programs that were deemed illegal by the World Trade Organization (WTO) and were repealed. In 2004, Congress enacted section 199 to replace these programs. The deduction was established to enhance the ability of U.S. manufacturing and other businesses "to compete in the global marketplace," and because "Congress should enact tax laws that enable small businesses to maintain their position as the primary source of new jobs in this country."<sup>iii</sup>

Facing intense international competition, architectural services were covered by section 199, as they were previously by the predecessor DISC, FSC, and ETI programs. Senator Kay Bailey Hutchison (R-TX), a strong proponent of the architectural services inclusion, said at the time:

*We know there has been a huge outsourcing of professional jobs overseas. This is becoming more common. Our architectural and engineering firms are particularly vulnerable to foreign competition.<sup>iv</sup>*

The need that section 199 is aimed at addressing -- to bolster the competitiveness of American businesses on the global stage -- continues to exist today and, in fact, is more pronounced. U.S. companies continue to face a competitive disadvantage internationally due to the tax system. This applies to the architecture industry.

Consequently, if section 199 is retained, we urge that it be retained for currently-eligible trades and businesses including architectural services. Narrowing section 199 would result in some industries doubly benefitting, while at the same time harming others. Industries included in section 199 would not only receive the section 199 deduction, but also benefit from the, albeit small, across-the-board marginal tax rate cut offset by excluding industries. In contrast, those industries excluded from section 199 would lose the section 199 deduction and receive only a small marginal tax rate cut, insufficient to compensate for the loss.

### **Conclusion**

As Congress considers tax reform, we urge: preserving tax policies support and strengthen small businesses; considering tax policies that support innovative, smart, energy-efficient, and resilient development; and ensuring fairness in the tax code. Tax reform following these principles would provide taxpayers with much-needed certainty, simplicity, and fairness, while at the same time encouraging economic growth and job creation.

The AIA and its members are ready to serve as a resource to Congress and the Committee on these and other issues.

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<sup>i</sup> AIA, *The Business of Architecture: 2014 AIA Firm Survey Report* (2014).

<sup>ii</sup> I.R.S. Chief Couns. Mem. AM2010-007 (Dec. 23, 2010).

<sup>iii</sup> Joint Comm. on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress*, at 170 (May 2005)

<sup>iv</sup> Cong. Rec. S5200 (daily ed., May 11, 2004) (statement by Sen. Hutchison).