Testimony Of

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On behalf of the

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On

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Thank you Madam Chairwoman for the opportunity to testify before the subcommittee on Oversight and Investigations of the Committee on Financial Services on behalf of the National Association of Home Builders (NAHB). NAHB represents more than 205,000 members involved in home building, remodeling, multifamily construction, property management, subcontracting and light commercial construction. NAHB is affiliated with more than 800 state and local home builder associations around the country. Our builder members will construct approximately 80 percent of the more than 1.6 million new housing units projected for construction in 2003.

The home building industry has been one of the strongest contributors to the national economy in recent years. We have had record years of production that have led to the highest homeownership rate in U.S. history -- 67 percent. It is in America's interest to assure that the home building industry maintains its leadership role in the economy, not only because housing and related industries account for 14 percent of the gross national product (GDP), but most importantly because of the benefits of home ownership to our country.

The subject of these hearings, the "Economic Growth Package" in the administration's FY 2004 budget, is a complicated proposal that affects a variety of issues of interest to the home building industry that warrant careful consideration and review by the committee. In addition to stimulating increased consumption and capital investment, these issues include interest rates, rates of return on tax exempt bonds, possible effects on targeted tax credits such as the Low Income Housing Tax Credit, the proposed Homeownership Tax Credit, New Markets Tax Credit, and Historic Preservation Tax Credit.

First, I want to say that NAHB supports President Bush and the Congress in their efforts to achieve an economic stimulus package that will provide near term stimulus to consumer spending and capital investment, including more housing consumption and production. NAHB supports changes in the Bush Administration's tax proposal or any Congressional tax proposal that will avoid unintended consequences that would be harmful to the housing industry such as increasing interest rates or the rate of return on tax exempt bonds, or negatively impacting housing affordability by lessening the value of targeted tax credits such as the LIHTC, the President's proposed HOTC, the New Markets Tax Credit and the Historic Preservation Tax Credit.

NAHB specifically supports the primary short term stimulus elements of the "Economic Growth Package" that would accelerate the implementation of changes in the tax law scheduled to take place in the future and increase capital formation incentives for small businesses. The accelerated changes in the tax code are tax rate reductions, an expansion of the 10 percent rate bracket, providing marriage penalty relief, and increasing the child tax credit. The small business capital formation proposal would increase the amount small businesses can annually expense from $25,000 to $75,000. We do, however, have concerns with some aspects of the Economic Growth Package. We are concerned about the possible consequential effects of eliminating the double taxation of corporate earnings, as well as, the failure of the package to include a housing component.

The primary focus of my testimony today is focused on the impact of the administration's proposal to eliminate the double taxation of corporate earnings on the LIHTC program. This is a complicated issue that requires some background information before it can be understood.

Background

Under present law "C" corporations, generally large corporations with many shareholders, pay federal income tax on their earnings. After the tax is paid the corporations either pay dividends to shareholders from the earnings or retain the earnings in the corporation. When a shareholder receives a dividend payment from a corporation, the shareholder reports the dividend as taxable income on his or her personal tax return. If the corporation retains earnings, the shareholder does not receive a direct benefit for the retained earnings. However, the retained earnings may produce an indirect benefit of increasing the value of the corporation's stock because the corporation has more capital.

The distribution of a dividend from taxed corporate earnings to a shareholder who then pays tax on the dividend is a double taxation of the corporate earnings. This double taxation of corporate earnings affects how businesses conduct their financial affairs and can create economic distortions. Many businesses avoid organizing as "C" corporations. They operate as pass through entities, i.e., business that pass through their items on income and expenses to the owners who report the items on their individual tax returns. When businesses operate as pass through entities there is only one level of tax and the double taxation of corporate earnings is totally avoided. Pass through entities are generally Sub Chapter S corporations and different types of partnerships.

Corporations that cannot do business as a pass through entity can minimize the impact of the double tax on earnings in a number of ways. Corporations may avoid raising capital though stock offerings and instead raise capital with debt. Interest payments on the debt are fully deductible, and as a result, less costly than paying dividends. Corporations also can buy back stock. To shareholders that sell their stock, the gain is a capital gain that is usually taxed at the capital gains rate of 20 percent, rather than higher personal income tax rates. The shareholders that do not sell their stock also receive a benefit from corporate repurchases of outstanding shares. As the number of corporate shares in the market declines, the price of the remaining outstanding shares tends to increase. Corporations also may retain more earnings than they would otherwise to avoid having shareholders pay additional tax on the earnings. By retaining the earnings, the value of the stock may increase due to the additional capital that the corporation keeps, especially if the corporation profitably uses the retained earnings.

Another way corporations can reduce the impact of the double taxation of corporate earnings is to reduce their tax liability. Corporations today can increase their earnings by buying Low Income Housing Tax Credits (LIHTCs) that can offset a dollar of tax liability with a dollar of tax credit. Corporations pay less for the credit than the amount of tax credit the corporation uses to offset its tax liability, producing a return on the transaction for the corporation. The increased earnings can be paid directly to shareholders as a dividend or retained in the corporation, indirectly benefiting the shareholders by increasing the corporation's capital. Today corporations make up approximately 98 percent of the market for LIHTCs. The large share of the market that corporations have is in part due to restrictions in the alternative minimum tax and on passive loss deductions applicable only to individuals. The LIHTC is considered a tax preference that is subject to AMT, which affects more and more taxpayers because the thresholds are not indexed. The passive loss rules limit the use of the LIHTC in offsetting the tax owed by individuals from non real estate investments.

The President's Proposal

The President's proposal to eliminate the double taxation of corporate earnings is accomplished in two ways. First, shareholders are entitled to exclude any dividend received from the taxable income they report on their personal tax returns that is attributable to taxed corporate earnings. The exclusion eliminates one of the two layers of tax that is currently imposed on corporate earnings. Second, shareholders are entitled to increase the cost basis of their stock by the amount of any retained corporate earnings that were subject to tax. The increase in the cost basis of the shareholder's stock reduces the amount of capital gains tax the taxpayer must pay if the stock is sold for more than its cost. This provision helps equalize the tax treatment of dividends and retained earnings in the proposal.

The president's proposal is expected to increase the amount of dividends paid because it will reduce the tax cost for the shareholders receiving the dividend. Since shareholders vote for the management of a corporation, corporate officers are expected to be compelled to increase dividend payments. The proposal also is expected to reduce the amount of capital raised with debt and increase the capital raised from stock issues because interest payments and dividend payments will be treated essentially the same. More businesses are expected to operate as C corporations than pass through entities because the adverse consequences of the double taxation of corporate earnings will be eliminated.

The relative beneficial changes to corporate earnings caused by the dividend proposal to other forms of investments will likely lead to a reduced rate of return on stocks because the amount received is not taxed. As a result, alternative forms of investment will likely experience a required increase in their rates of return in order to remain competitive. These other forms of investment include taxable and tax exempt bonds, interest earning accounts, and real estate, including home ownership.

The macro economic effect of the proposal will likely result in more employment and a higher level of economic output, at least in the short run. Corporate stock values should increase. In the long run, interest rates may increase because of additional federal borrowing due to an increased federal deficit. An increase of approximately 75 basis points in long term interest rates is predicted by Macroeconomic Advisors (MA), LLC, one of the premier economic analysis firms in he country.

Tax Effects Of the Dividend proposal On the LIHTC

Unfortunately, the dividends exclusion proposal reduces the value of tax credits like the Low Income Housing Tax Credit (LIHTC). The value of tax credits is reduced compared to today's value of the tax credits because corporate earnings that are exempted from tax by the credit are taxable to the shareholder and will not increase the cost basis of the shareholder's stock when the corporation retains the earnings. Today, the use of the tax credit by the corporation has no effect on the tax treatment of dividends paid to the shareholder or the cost basis of the shareholder's stock, i.e., there is no tax cost to the shareholder for the use of the credit by the corporation. The reduced value of the credit due to the change in the tax treatment of corporate earnings is expected to lower the price corporations will pay for the LIHTC.

The computation that reduces the value of the LIHTC relative to the current treatment is performed as follows. In order to determine the amount of the corporation's dividend that is either exempt from tax at the shareholder level or used to increase the cost basis of shareholders' stock, the corporation must perform a calculation to determine it's excludable dividend amount (EDA). The shareholder's excludable portion of any dividend received is the amount of the dividend payment that bears the same ratio to the dividend payment as the amount of the corporation's EDA to all dividends paid by the corporation. If EDA exceeds the dividends paid during the year, the cost basis of the shareholders' stock is increased by the amount of EDA the corporation did not pay out as dividends.

The computation of EDA that affects the value of tax credits is:

$$\text{EDA} = \frac{\text{Federal Income Tax} - \text{tax credits except for the Foreign Tax and AMT credits}}{\text{Highest Corporate Income tax Rate (35 Percent)}}$$

In the formula above, the amount of a corporation's EDA is reduced when tax credits like the LIHTC are subtracted from the corporation's Federal income tax. When the amount of federal income tax is reduced, a smaller EDA amount is computed after the federal income tax is divided by the 35 percent corporate tax rate. As EDA becomes smaller, the portion of the shareholder's dividend that is excluded from the shareholder's income is also smaller. The ratio or the shareholder's excluded dividend to the overall dividend paid to the shareholder is the same as the ratio of EDA to all corporate dividends. In addition, when the amount of EDA is made smaller by subtracting credits from the corporation's federal income tax, the amount by which EDA exceeds dividends paid also becomes smaller. As a result, there is less EDA excess over dividends paid to increase the cost basis of the shareholder's stock.

The impact of the administration's dividend proposal on the price that will be paid for tax credits such as the LIHTC depends on the mix of dividends paid and taxed earnings retained in the future. The value of the LIHTC is more adversely affected if more dividends are paid relative to earnings retained (i.e., the more tax benefit forgone, the lower the value of the credit). Since the proposal is designed to eliminate a bias against paying dividends, it is likely that dividend payments will increase relative to the current level of dividend payments.

The value of a dividend exclusion to the shareholder is based on the shareholder's current income tax rate that can be as much as 38.6 percent under present law or 35 percent if the stimulus package is enacted into law. The value of the dividend benefits the shareholder in the year the dividend is paid. If the LIHTC is used to increase earnings to be distributed as dividends in the future, the credit will have to generate enough extra earnings so that the shareholder can pay the personal income tax on dividend while still getting as much of the dividend as the shareholder would have received tax free without the use of the credit.

Shareholders receive less of a benefit when the basis of the shareholder's stock is increased as a result of the corporation retaining taxed earnings. The shareholder does not realize the value of the increase in the stock's cost basis until the stock is sold. At the time of sale, the shareholder will probably be subjected to the 20 percent capital gains rate on the difference between the stock's cost basis and its sales price. The capital gains tax that is not paid on stock sales because of the increased cost basis of the stock is less that the ordinary income tax that is not paid when tax free dividends are distributed. In addition, the smaller tax benefit of the stock cost basis adjustment must be discounted to its present value because it will not occur until some point in the future.

Operation Of The LIHTC Program

The LITHC program produces 115,000 units of affordable housing each year. Credits are allocated by state agencies and claimed by investors over a 10 year period. The affordable housing property must stay in compliance with the requirements of the LIHTC program for 15 years for investors to avoid a recapture of the tax benefits of the credit they claim over the 10 year period.

Affordable housing built with the LIHTC has different layers of support and operates on narrow margins. States try to serve the lowest income tenants possible and locate affordable properties in areas where development frequently is difficult, such as rural and inner city areas. A developer who sells the LIHTC to investors uses the proceeds from the sale as equity in LIHTC properties. The amount of equity generated with the credit reduces the debt financing the property must carry. As a result, rents lower than market rates can be charged to eligible tenants, i.e. tenants at or below 60 percent of area median income, because less debt is carried on LIHTC properties than on market rate properties.

There are other factors that affect the purchase of LIHTCs and influence the analysis of the impact of the dividends proposal on the credit. Some purchasers of the LIHTC are in the business of investing in real estate and can be expected to continue to invest in the credit as part of their business. Although these businesses will remain a part of the market for purchasing credits, they will buy the credit at market prices if prices decline. If companies that are not in the real estate business reduce their purchases of LIHTCs, the price of the credit may go down despite the continued interest of businesses in real estate. Some businesses purchase credits because they are subject to legal requirements that credit purchases satisfy, such as the Community Reinvestment Act (CRA). The credit is purchased today to meet these requirements. While the credit will continue to satisfy the obligation of these firms under CRA, other forms of investments can be made to satisfy CRA requirements. As result, the alternative investments may become more attractive when the value of purchasing the credit is reduced by the dividend proposal, reducing the CRA-driven demand.

Effect of the Dividends Proposal on the LIHTC Program

Even a modest change in the value of the credit and the resulting reduction in the amount of equity the credit can generate will have adverse consequences on the LIHTC program. When the credit is worth less, corporations will pay less for the same amount of credits than they pay today and less capital will be available to invest in affordable housing properties.

Dividend Proposal

Two studies have been published to date that analyze in impact of the administration's dividend proposal on the LIHTC program. The first study released was prepared by Ernst & Young (E&Y) for the National Council of State Housing Agencies (NCHSA) that predicted there would be a reduction of 40,000 LIHTC units per year, which is a 35 percent reduction from the current level of 115,000 units that will affect 80,000 people. The Mortgage Bankers Association (MBA) published the second study. The negative effects of the dividend proposal on the LIHTC program was driven by a 21 percent decrease in the prices for the credit due to the tax change in corporate earnings. The MBA study predicted the dividend proposal would actually benefit the production of LIHTC units and have virtually no negative effects at all.

There are many assumptions that must be made to perform an analysis like the E&Y and MBA studies. We believe the static assumptions in the E&Y study result in too much emphasis being place on the effects the proposal would have on the production of units. The changes induced by the full tax proposal will provide an incentive for some firms to become Chapter C corporations that are now Chapter S, which will provide new demand for the LIHTC. Some corporations that have average tax rates below 35 percent will benefit from the EDA calculation that uses an average tax rate of 35 percent. Such corporations will effectively be able to pass more of the benefit of the credit to the shareholder without tax. The combined effect of more demand for the LIHTC from new sources is uncertain but in the direction of tempering the price impact. It is not clear to us how the MBA study was actually performed. We are continuing to review it now.

It is our best estimate at this point that the 21 percent estimate of the price reduction in the E&Y study is overstated and that the emphasis on units produced in the analytical formula fails to reflect the full range of the impact of the dividend proposal. NAHB estimates that a more realistic decline in the value of the credit is 10 to 15 percent. We also believe that there will be significant revisions in state priorities for the LIHTC program if the dividend proposal is enacted into law. Higher income tenants will be sought and fewer properties will be built, particularly in hard to develop area.

LIHTC properties are financed in three layers – equity, soft gap funding and first mortgage debt. While the exact impact of dividend proposal on the amount of equity available for LIHTC properties is still open to question, it seems certain that a significant erosion will occur, requiring offsetting increases in the other funding slices. Most observers agree that current federal and state sources of soft financing/grants are already fully tapped. That leaves first mortgage debt financing as the only available offset and unfortunately, as discussed below, this avenue has severe limitations on expansion.

These limitations, simply stated, revolve around the difficulty in increasing rental income from LIHTC properties. Loans for LIHTC properties are underwritten on the basis of the capacity of the ongoing net operating income of the property (the margin of rental and other income over operating expenses and reserve payments) to cover mortgage payments. Lenders establish minimum debt coverage or debt service ratios (DCRs) that determine how much mortgage debt a property can support. Fannie Mae, for example, enforces a debt service ratio of 1.15 percent, requiring properties to generate operating income significantly in excess of expenses. Other financing programs require DCRs in the 1.10 to 1.20 percent range.

Such limitations on debt coverage greatly limit the capacity of LIHTC properties to take on additional debt needed to significantly offset the expected reduction in equity funding. Rents on eligible LIHTC units by law cannot increase above 30 percent of 60 percent of area median income. This is the constraint producing the program's unusually low loan-to-value ratios. Therefore, the impact of the dividend proposal provision on the number of units produced and the characteristics of households and areas served will be well beyond incidental and ultimately determined by the capacity and willingness of state allocating agencies to fund properties at higher rent levels.

Adjustments are possible. State allocating agencies strive to serve households at the lowest income levels possible. The states could redirect the program to those earning closer to the maximum statutory limit of 60 percent of area median income. States also likely will attempt to allocate more credits to properties than they do today in an effort to reduce debt requirements. Reducing service and increasing rent loads for low-income families is not likely to be a welcomed option and will be limited by the facts that any increase in incomes served would come from levels that are, in most cases, not that far below the statutory maximums and market rents in many areas would not permit significant or any rent increases. This would be particularly true in rural and economically distressed urban areas.

These factors lead NAHB to conclude that the dividend proposal component of the President's proposal would have a significant adverse impact on the supply of rental housing available for low-income families. This effect would take the form of a sizable reduction in the number of units produced each year, as well as a shift in the composition of the units produced away from those serving families at lower income levels and located in rural, urban and other difficult to develop areas.

Solutions:

There are two approaches that can be used to avoid a negative impact of the administration's dividend proposal on the LIHTC. The first approach would be to exempt the LIHTC from the adverse effects of the elimination of the double taxation of corporate earnings. This can be done within the structure of the administration's proposal by treating earnings corresponding to the LIHTC as taxed earnings. Other methods of not affecting the LIHTC by a dividend proposal would involve structural changes the proposal such as exempting all or part of dividends received by shareholders as exempt from tax or by shifting the tax benefit of eliminating the double taxation. The tax benefit could be shifted to a corporation with a corporate deduction for dividends paid.

The other approach to protecting the LIHTC from the adverse consequences of the administration's dividend proposal would be to make up for any adverse impact on the credit from the dividend proposal by expanding the availability and the market for the credit. This proposal requires adjustments to the program and other parts of the tax code that limit the market for the credit.

1. Exempting the LIHTC From The Effects Of The Dividend proposal

a. Treat Earnings Excluded from Income by the LIHTC as Taxed.

This option would treat corporate earnings that are not subject to tax because of the LIHTC in the same fashion as earnings subject to foreign taxation and exempted from federal taxation by the Foreign Tax Credit (FTC) or earnings that were previously subject to the AMT and credited for past payments of that tax. The proposal exempts the LIHTC from the impact of the dividend proposal because the earnings that are exempted from tax by the LIHTC are treated as taxed earnings that can be paid out as tax free dividends or used to adjust the cost basis of a shareholder's stock. The solution fits into the format of the dividend proposal in the Economic Growth Plan without changing the basic structure of the proposal.

As discussed above, EDA is computed with the following formula:

$$\text{EDA} = \frac{\text{Federal Income Tax} - \text{tax credits except for the Foreign Tax and AMT credits}}{\text{Highest Corporate Income tax Rate (35 Percent)}}$$

If the LIHTC were added to the FTC and AMT credit in the formula, the adverse consequences of the dividend proposal on the LIHTC would be avoided.

b. Equivalent Solutions To Treating LIHTC Excluded Earnings As Taxed.

There are other approaches that could accomplish similar results as the FTC treatment of the LIHTC. For example, providing corporations with a dividends-paid deduction for dividends paid to shareholders from taxable earnings and a capital basis adjustment for shareholders' stock when taxed earnings are retained by the corporation, or, provide shareholders with an exclusion (with or without a limit) for dividends received would effectively protect the LIHTC from the adverse consequences of a dividend exclusion. In fact, the Treasury Department made such a proposal in 1992 in "A Recommendation for Integration of The individual and Corporate Tax Systems." The Treasury Department's 1992 proposal would exempt all dividends received by a shareholder from ordinary income taxes. A capital gain tax would apply to dividends that represent a return on capital rather than ordinary income earned by the corporation.

2. Expanding LIHTC Limits and Market

Today's LIHTC market among individuals is limited by limits on passive loss deductions and the imposition of the alternative minimum tax. Eliminating these restrictions could substantially expand the LIHTC market. However, removing these restrictions would not fully compensate for reducing the corporate market for LIHTCs due to the administration's dividend proposal. Individuals cannot be expected to pay as much for the credits as the current group of corporations that make up the market. The corporations are in a better position to assess the risk of purchasing credits and require a lower rate of return than investors who cannot perform the same level of risk assessment. As a result, if the program is to be maintained at current levels by expanding the market for the credits among individuals, the amount of credits that can be sold to raise equity, as well as the amount of credits that can be dedicated individual properties, would need to be increased to make up for inefficiencies in the individual market. A more detailed discussion of these changes follows.

a. Increase the amount of LIHTC individual investors can take annually against ordinary (non-passive) income.

The current very low deduction limitation—$25,000—on the amount of LIHTC individual investors can take each year to offset individual ordinary income tax liability should be raised or eliminated. The current limit has all but eradicated the market for the LIHTC among individuals, which reduces demand for LIHTCs and, consequently, the amount available each year for the apartment investment the LIHTC can generate from any particular amount of LIHTCs.

b. Allow the use of the LIHTC to reduce Alternative Minimum Tax (AMT) liabilities.

Individuals use the LIHTC to reduce their regular tax liability. However, the LIHTC cannot be used to offset the Alternative Minimum Tax ("AMT"), which applies to increasing numbers of individuals. To the extent that potential LIHTC investors are subject to the AMT, they either pay less for the LIHTCs they buy, reducing the dollars available from the LIHTC for housing, or may refuse to buy LIHTCs at all. Providing an exemption from the individual AMT would increase the marketability of the credits and help alleviate any reduced value due to the elimination of the double taxation of corporate earnings.

c. Remove LIHTC Limits per Project & Increase the volume cap on LIHTCs

Currently, the volume cap on LIHTCs is $1.75 per capita per state indexed for inflation and with a "small state minimum" of $2 million. LIHTCs per project are limited to four percent and nine percent of total development costs, depending on the type of transaction.

This proposal fills the financing gap due to the administration's dividend proposal by eliminating the four and nine percent credit limits per project, allowing states to put as much credit as is needed (subject to the required feasibility analysis by the allocating agency) into an individual project. The increase in credits per project is necessary because less capital will be raised by the LIHTC from the individual market than the current corporate market. An increase in the state per capita allocation and minimum state allocation must also be made to keep the program at current operating levels to make up for the additional credits each project will require. Without more credits per state, some projects would be fully funded while others would not be funded and a net loss in affordable units would result. If more credits per state under the per capita and minimum state allocation are allowed, then the current level of production could maintained, even with a lower credit price due to the inefficiencies of the individual market.

Madam Chairwoman, that concludes my remarks. I urge you to consider the unintended adverse consequences of the Economic Growth Package on the LIHTC and devise solutions that will keep the program operating at the same levels as it does today. NAHB looks forward to working with you and your committee, as well as the Ways and Means Committee and Treasury Department to fully protect the LIHTC.

Thank you for having me here today.