task force

TEAM IV
PROGRAMS and POLICIES

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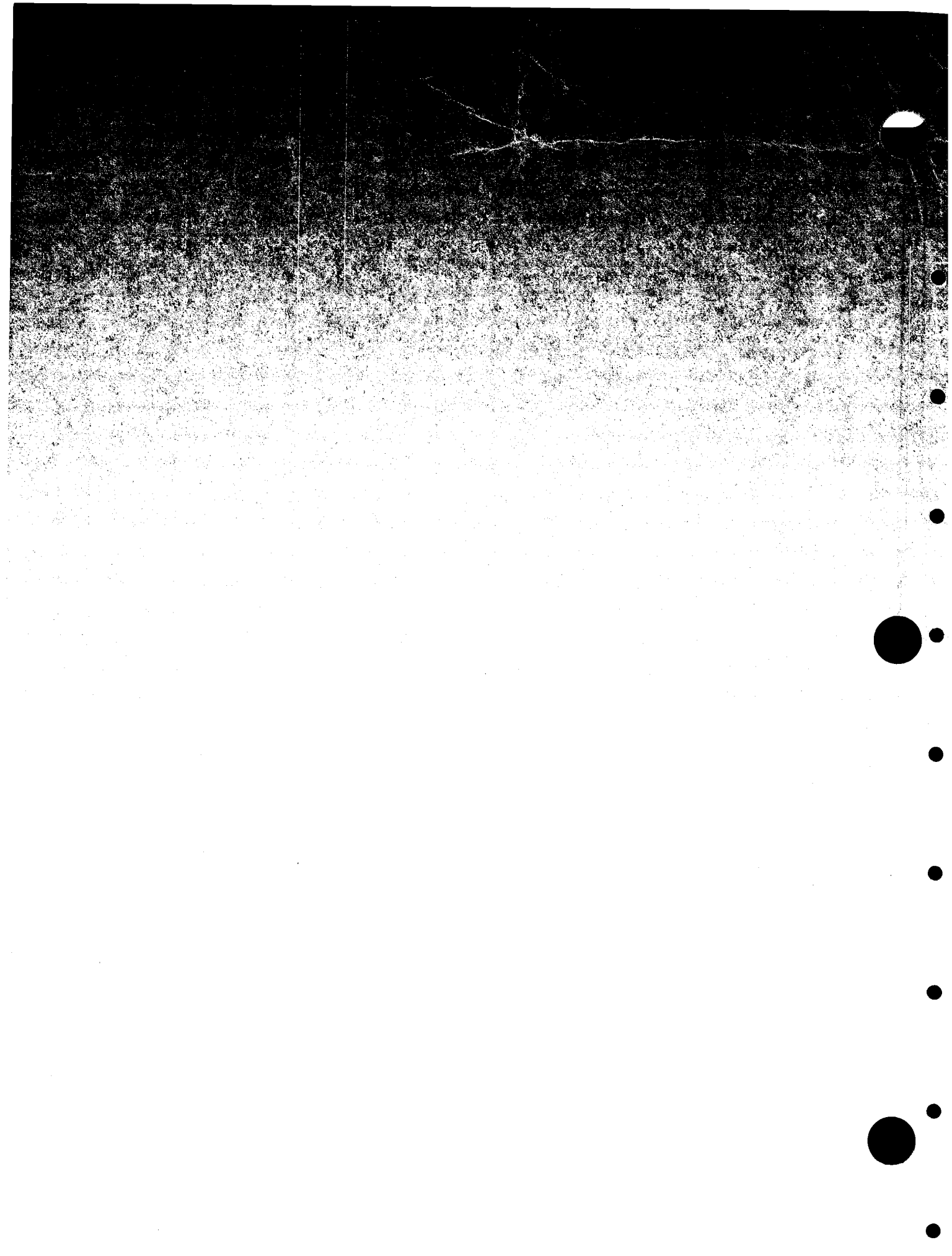

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In-House

Tax Law and Policy

ABSTRACT: This paper outlines several alternative Federal tax proposal designed to compliment any one of a number of program alternatives presently under consideration by the Housing Review Task Force

Discussion Draft No. 2 Date 6/22/73

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Preface

This paper presents four principal tax proposals, in descending order according to our analysis of their practicality and effectiveness. These proposals are outlined in detail in Section IV and their application to substantive alternatives is discussed in Section V. It is anticipated that each of these tax incentives would cost the government substantially less than the existing incentives because any new recommendations would be geared to an investment group with a lower income than that which now benefits from the accelerated depreciation provisions. We have refrained from performing specific cost comparisons until such time as substantive program alternatives are developed because we are uncertain as to how much subsidy should be provided via the tax system. Therefore, we have developed a computer model which forecasts costs and calculates anticipated yields. As soon as the appropriate policy decisions regarding program alternatives are reached, we can make the necessary cost comparisons between the existing tax benefits and those reform proposals which might be appropriate.

Summary:

I. Introduction

Investment in real estate has long been an important area of financial growth. To date, the tax incentives provided investors have played a significant role in determining how and where such investments should be made.

A. Issues - Should the Federal Government continue to provide tax incentives to investors in order to motivate them to invest in residential real estate generally and low and moderate income housing specifically.

1. Pros - Urban problems indicate some malfunctioning of the free market system. Public intervention through the tax system is necessary to overcome such market mechanism defects and provide income redistribution and/or consumer subsidies. It has also been successful in generating a great deal of new housing construction. As a practical matter it has always been easier to legislate a tax benefit than a direct subsidy.

2. Con - Any tax incentive is wasteful, inefficient and inequitable. The current costs of syndication are inordinately expensive. Compensation bears no relation to risk; instead, they relate

to the superflous question of the tax bracket in which the investors happen to be.

3. Recommendations - The current system of tax incentives relating to housing should be reformed. New incentives (or direct subsidies) should be provided.

II. Alternatives (in order of preference)

A. Tax Credits

1. Construction Credit - designed to encourage multifamily investment by offering a fast recovery of capital. It would replace current deductions for construction costs and interest.

2. Management Credit - to permit faster recovery of capital expenditures for upgrading and maintenance of buildings.

3. Per Unit Credit - a prorated credit (perhaps computed on total number of units within the development) given to owners who either provide or rehabilitate units, within new or existing buildings, to low and moderate income people.

4. Pros - Credits could increase investments from two major sources, heretofore untapped.

a. lower-income taxpayers

b. large corporate and institutional investors

Tax credits are more equitable and simpler to administer than accelerated depreciation.

5. Con - Reformers can still point to the fact that credits allow special treatment for certain taxpayers.

B. Direct Subsidies

1. Burgess Task Force - eliminate current tax incentives and establish a new ownership entity called a HOME. Federal Government would provide developer with a direct subsidy and the ownership entity with a management fee.

   a. Pro - System is more equitable and efficient. It would provide additional incentives for persons interested in long-run business performance and growth and is less expensive than current system.

   b. Con - The whole emphasis is on new housing which may accelerate ~~depreciation~~ obsolescence of existing stock. Because the proposal represents a totally integrated system, it will be difficult to make any modifications that would give rise to the same kind of flexibility available from tax credits.

2. Wallace Recommendation - eliminate current tax incentives and substitute a direct subsidy to developers. Continue current system of interest subsidy payments with no increased fees for management. This is a front end-capital grant and if its not included in the mortgage it

would have the effect of reducing rent.

a. Pro - Retains present market structure. More flexible than the Burgess proposal - could eliminate interest subsidy payments and allow rents to increase, thereby only providing subsidy to moderate and middle income people.

b. Con - Problem of ownership significant. If government eliminates current tax incentives and provides front-end costs plus mortgage insurance there is no capital investment. Hence, who owns the property? Burgess uses the HOME to overcome this difficulty.

3. Recommendation - Initiate a system of tax credits and obtain an exception from Treasury Reform Proposals, regard LAL for low and moderate income housing.

III. Encouraging State and Local Responsibility

A. Housing Allowance

1. Since a limited housing allowance program requires availability of existing units, HUD should seek to modify LAL proposal to exclude application to Section 167K.

2. Provide a tax credit for expenditures on rehabilitation of existing real estate for which housing allowance is utilized.

3. Permit HA recipient same tax benefits from deductions for interest and property taxes as are available to other homeowners.

4. Provide low income recipients with a tax credit for property tax paid which exceed a fixed percentage of income.

5. Provide a per unit tax credit for purposes of motivating owners to rent to housing allowance recipients. If new construction is desired an investment credit might be useful. Management credit could be used to maintain and upgrade both property and individual units.

B. Revenue Sharing

There are two tax policy alternatives that might prove compatible with this program alternative. The first assumes that the revenue sharing payment will equal the total subsidy currently available through HUD and the tax system. If that be the case HUD should:

1. Support LAL - The LAL provision is designed to eliminate the benefits of excess depreciation. If the first set of assumptions are accepted there would be no need for accelerated depreciation.

2. Eliminate accelerated depreciation - as above; but retain straight-line depreciation for all rental residential real estate.

3. Substitute an investment credit (or other system of credits) for non subsidized projects so that rents can be kept reasonable.

A second less desirable alternative is to:

1. Support LAL - and continue the existing tax incentives, e.g., accelerated depreciation, expensing construction costs, recapture, etc. for non subsidized projects.
2. Provide less of a revenue sharing payment - so that the states are only able to provide a shallow subsidy. This would provide housing for moderate and middle income families. Hopefully, "filtering" would work to provide low and moderate income housing.

C. Tinkered Section 236

1. Support LAL - If HUD provides developers with a sufficient direct subsidy to offset construction costs.
2. Modify LAL - If tinkered program does not provide investors with a competitive rate of return, HUD should oppose LAL as it relates to the 236 program. Opposition can take two forms:
   a. retention of existing incentives
   b. substituting a tax credit

D. No Subsidy

Under this proposal HUD only offers mortgage insurance.

1. Modify LAL - so that you retain current incentives. If no other subsidies tax system can not handle job alone, HUD should at least provide the most beneficial environment for investment - accelerated depreciation.
2. Limit time effect of LAL - so that one can evaluate effect on market.
3. Provide tax credit for insured projects - as an additional incentive for development of low and moderate income housing.

Table of Contents

Tax Law and Policy

I. Introduction

Investment decisions concerning real estate have long been critical to urban development. It is important to recognize that evaluation of risk and selection of method of investment are often strongly influenced by tax considerations. Therefore, the Tax Reform Act of 1969, perhaps the most sweeping reformation in the history of this Nation's tax system, was extremely significant because it had particular impact on residential rental real estate.

The most dramatic reforms relate to depreciation. Under prior law, depreciation could be computed by either a straight-line or an accelerated method. Generally, in the case of newly constructed property, the taxpayer could employ the sum-of-the-years-digits method or the double declining balance method (200% of the straight-line rate). In the case of used property, the declining balance method at 150% of straight-line was available. Again under prior law, a portion of the gain realized on the sale of real property was taxed at rates applicable to ordinary income, rather than capital gains rates; it was calculated by a percentage of the depreciation (in excess of straight-line depreciation) deducted after December 31, 1963 (when the

recapture rules were first made applicable). The percentage of this "excess" depreciation which was subject to recapture was reduced in proportion to the length of time the property was held. After ten years, there was no recapture at all and all gain was taxed at capital gains rates.

The 1969 Act created an entirely new system for depreciation of real estate. Section 167(j)(2) of the Internal Revenue Code provided that prior law would apply to new residential property constructed after July 24, 1969. All other new properties, such as shopping centers and office buildings would be governed by the provisions of Section 167(j)(1) and could be depreciated at 150% of the declining balance. Used residential property acquired after July 24, 1969, was permitted to use 125% of the declining balance. All other property would be governed by Section 167(j)(4) and would be permitted only the use of the straight-line method of depreciation. Finally, Section 167(k) provided that rehabilitation expenditures made between July 24, 1969 and January 1, 1975, for the purpose of providing rental housing for low-income persons, could use the straight-line method over a very short period, five years, provided certain conditions were met.

During the time the Act has been in effect, there has been much discussion concerning its effectiveness.

Professor Paul Taubman (in a Team IV paper appended to this paper) suggests that two criteria exist which are useful in evaluating the effectiveness of tax subsidies. These are "equity" and "efficiency".[1] Equity refers to both the horizontal aspects and the vertical aspects. A tax subsidy can be considered unfair if it is not equally available to equals or if it distorts the socially agreed upon progressiveness of the tax law.

Efficiency is measured differently. "An efficiently organized economy is one in which marginal social costs and benefits are equalized."[2] Since individual rationality in a free market society is based on free choice generated to some degree by self-interest, there are certain societal goals which would ramain unachieved were it not for an outside subsidy. Thus, if private and social benefits are not identical, the subsidy may increase efficiency. However, correcting for the discrepancy in one industry alone is unlikely to increase social benefits throughout the whole society. Private and social benefits can differ and recognition of these countervailing forces can be useful in policy formulation.

1/ Paul Taubman, "housing and Invcme Tax Subsidies: A Report To The Department of Housing and Urban Development, May 15th, 1973, p. 19

2/ Ibid., p. 23

Another problem which relates to the equity and efficiency criteria is the question of how taxpayers perceive the administration of the tax system. The success of our system of tax collection is predicated on honest and voluntary taxpayer participation. If taxpayers feel that the tax system is unfair because of too many "loopholes", many people will become disenchanted and unwilling to participate voluntarily. Instead, they will cheat in their tax submissions, evade the payment of some or all of their taxes, and otherwise vent their frustrations against the government.[3/]

Reformers have also complained that subsidies afforded through tax provisions are not subject to the same kind of regular Congressional scrutiny as are direct subsidies. Once enacted, tax incentives have also been very difficult to repeal. Thus, some tax subsidies have outlived their usefulness.[4/]

II. Effectiveness of Existing Tax Incentives

Although this subject is to be discussed in detail in Team III papers, certain assumptions and conclusions concerning the existing tax incentives will be made and expressed herein as a foundation for the recommendations which appear subsequently in this paper. The availability

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3/ Ibid., p. 25

4/ Ibid.

of accelerated depreciation and capital gains treatment with respect to developing rental housing has probably increased the number of units built and the amount of initial expenditures for such buildings. At the same time, these incentives may have a negative effect on project maintenance and longevity. The capital gains provision and the decline in the annual interest deduction favor relatively rapid turnover in ownership. Some feel that this turnover leads to under-maintenance because an owner is able to leave before the effects of the under-maintenance turns into an expense he must bear himself. Professor Taubman, noting that there is little empirical work which bears directly on this hypothesis, states that economic theory suggests this outcome. He argues that any outside investor would find it difficult to establish the exact quality of a building which appears superficially in good shape even though under-maintained. Thus, he would be willing to pay the owner a higher price for the property than was necessary. Although all experienced investors would know that the quality of the average building was lower than it appeared, enough investors would purchase on the basis of appearance or other considerations that it would pay all owners to under-maintain. Thus, the average maintenance and quality would be less under a system that encourages rapid

turnover than when the consequences of shoddy maintenance are internalized through a system that encourages long-term ownership.[5/]

In addition, it appears that the present system of providing tax incentives is unnecessarily expensive. "Sponsors", under present programs, must obtain compensation by syndicating (selling the tax subsidy to someone else). The wealthy investors, who can utilize the tax losses pay the sponsor less than the total cost of the tax subsidy to the Treasury. This process also forces the sponsor to engage in an additional step (beyond constructing housing) in order to obtain compensation.[6/]

Because the current system relies on tax losses, which are more valuable to investors in the higher brackets, it excludes potential investors who are in lower tax brackets. Moreover, the profit generated by the use of these tax subsidies does not reflect the risks involved in developing a project. Rather, the amount of profit is dependent on which tax bracket the investor happens to be in.[7/]

5/ Ibid., p. 28

6/ Burgess Task Force Report on Multifamily Housing, Chapter IV, p. 15

7/ Ibid., p. 28

Finally, under the present system the tax benefits run out within twenty years after completion of the construction of the project although HUD-insured mortgages are generally for a term of 40 years. Based on tax considerations, after the twentieth year, there is little reason for the owner to continue to hold the project. In fact, there may be substantial incentives to sell it. As less interest is paid, more principal is paid - and the latter is not deductible. This loss of deductions plus possible need for additional cash investments for maintenance may combine to make the project unattractive both to original investors and to their successors.[8/] On the other hand, cash flow may remain positive, the deduction may be less important, and the project may increase substantially in resale value. This appears unlikely but we have little experience as yet ~~at~~ ON this point.

In summary, the tax subsidy system has worked insofar as attracting investment but the true cost may be unnecessarily high. Some of this incentive should be transferred to builders and managers. If housing programs continue to require outside investment capital, then a more limited benefit should be developed. This does not mean that all tax incentives should be eliminated but it does mean that the present

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8/ Ibid., p. 21

ones should again be "reformed."

III. The Administration's Tax Reform Proposals

The Administration's tax reform proposals, as presented to the House Ways and Means Committee on April 30, 1973, are an attempt to correct some of the inequities resulting from the present use of accelerated depreciation. Under the proposal, an individual will not be permitted to offset so called "artificial accounting losses" against unrelated income. ("Related income" is that income which is derived from similar kinds of investment sources). Such losses can only be deducted from related income, and the nondeductible part must be held in a Deferred Loss Account. Thereafter, it can be used to offset future gains from the asset which ~~the~~ generated the losses or against other related income generated by similar investments.

> The recommendation provides that this Limitation on Artificial Accounting Losses (LAL) will apply to: (a) oil and gas (deduction of intangible drilling costs), (b) net leased personal property (deduction of amount of accelerated depreciation and amortization over straight line amount), (c) rental real estate (see explanation below), (d) livestock and farming (prepaid feed and other such expenses).

In the case of real estate held for rent or for sale as rental property, the recommendation provides that LAL will apply to those artificial accounting losses attributable to the amount of accelerated depreciation taken in excess of the straight-line amount and the

amount of amortization under Section 167(k) (rehabilitation) in excess of the straightline depreciation amount. Likewise, LAL will also apply to "pre-opening" and otherwise deductible construction period costs (interest, taxes, legal fees, insurance etc.) which precede the income to which they relate.

As previously indicated, the artificial loss may be deducted from "related income". In the case of residential rental real estate (both rental housing and rental housing held for sale) "related income" includes rental income from all residential real estate, plus income from sale of rental housing held primarily for sale. In the case of nonresidential real estate, "related income" includes only rental income and sales income from the particular property to which the accelerated deductions are attributable. Each building would be treated as separate property except in cases where one or more buildings are situated on a single tract or parcel or on contiguous tracts or parcels and are operated as a unit. Under those circumstances, such buildings would be treated as a single property.

To date, it is unclear to what extent the Treasury recommendations exempt housing constructed under HUD subsidized programs. Informal discussions with Treasury officials indicate that their preference may be to include government-assisted programs within the scope

of the proposal, provided the HUD Housing Policy Review Task Force does not make any recommendations to the contrary. This means that in the event HUD reactivates a Section 236 type program, investors in such projects could no longer deduct excess accounting losses from unrelated income. However, such losses could be used, even by passive investors, to offset other residential real-estate investments. Although discussions with industry representatives indicate the contrary, Treasury officials have expressed the belief that losses from investments in low and moderate income housing could be offset against income from conventional real-estate projects to reduce the taxable effects of a positive cash flow and increase an investor's after-tax rate of return.

According to Treasury, the proposal is designed to encourage the formation of "mix and match" residential tax investment entities. They have assumed among other things, that investors are willing to pool risks of low and moderate income housing with the differing risks of other residential property. However, it appears that no one has tested this assumption or its significance. In fact, in its desire to promote equity within the entire tax system, the Treasury failed to consider carefully the implications of its proposal on the real estate industry in general, and subsidized housing in particular.

Presently, construction interest and property taxes are "expensed" (i.e., deductible) in the year actually paid out. The Administration's proposal would permit deduction of these items only against residential rental income; if the taxpayer did not have such income, he would have to "capitalize" the construction interest and property taxes (i.e., add them to his basis in the project) and claim depreciation deductions on those amounts over the useful life of the building. This change would significantly reduce the realized yield on realty investments.

The following analysis of a typical apartment project explains some of the factors involved (it is taken from testimony presented by Philip Brownstein before the House Ways and Means Committee). The sample project is a conventional rental apartment; 144 units; total cost of $2.4 million, of which $180,000 was the cost of land acquisition; mortgage amount of $2.1 million; $300,000 in equity is owned by taxpayers in the 50% bracket. The mortgage loan costs and permanent financing fees amounted to $193,000. It is assumed the project will attain a 95% occupancy within a year after completion. Under existing tax law, projected monthly rentals for this development would be $263 per unit. If the depreciation allowed were limited to that which would be permitted under the straight-line method, rents would have to be increased to $297 in order to obtain the same

effective yield which would have been received by an investor using the double-declining balance method.

If the tax incentives are substantially reduced in the manner suggested by the Treasury, net yields will be reduced, participation by outside investors will diminish, and housing development in general (and Section 236 in particular) would slow sharply. Even if the moratorium were lifted, the limited dividend (6%) feature of the Section 236 program combined with elimination of the accelerated depreciation shelter for non-related income, would effectively eliminate investment in the subsidized area. Without these market supports, alternative investments would become more attractive to the investor and housing starts would decline.

As housing starts decline, vacant units will become increasingly scarce, and rents will rise. It is unlikely that the average renter could benefit sufficiently from these proposed tax reforms to offset his increased living expenses. This paper, therefore, recommends that tax benefits be retained to support rental housing development though it maintains that the existing incentives should be substantially reformed. Otherwise, the renting public may be harmed both socially and economically by the unavailability of adequate housing units.

IV. New and Improved Subsidies for Housing

Most of the Internal Revenue Code subsidies for housing are expensive. They provide tax shelter for upper-income persons. They tend to act as disincentives to proper maintenance and repair and may lead to the artificial shortening of the useful life of buildings.

It is important to remember that tax shelters related to housing must compete in attractiveness with other forms of tax shelters. Thus, no matter what the nature of the housing tax shelter, if all other shelters were terminated, housing would be the recipient of an enormous volume of investment funds.[9/] Likewise, if housing were put at a disadvantage investors would seek alternative investments.

In the discussion which follows, four improved tax subsidy approaches are proposed (in descending order on the basis of practicality and effectiveness).

A. Tax Credits and Modification of Subchapter "S" Rules

If it is decided to continue to attract equity financing into the housing market in order to promote the availability of low and moderate income housing, use of a tax credit for investment and maintenance purposes will probably be more equitable than any other form of tax incentive. Unlike accelerated depreciation, the absolute amount of the tax credit need not increase dependent on the taxpayer's tax bracket. The amount of

9/ Op Cit, Taubman p. 41

the credit can be fixed and its availability and amount can be adjusted easily.

We propose a three-fold credit which would work as follows:

1. Construction System of Credit. This credit would encourage construction of multifamily units by affording equity investors a rapid return on their invested capital. This credit could be computed on the basis of a flat rate per unit, or as a percentage of unit cost. In a sense, it would replace the current deductions for construction interest and property taxes; the taxpayer would be required to capitalize these items.

2. Annual Management Credit. This credit would permit a rapid recovery of capital expenditures for the upgrading and maintenance of buildings and equipment. The credits would be based on the total development cost of the project (excluding land costs), provided the building met specific management standards. We are exploring the implications of conditioning the receipt of any tax benefits on the requirement that the property, to be eligible, must meet local building code standards. The credit would be received each year, in addition to straight-line depreciation, and would replace all forms of accelerated depreciation currently allowable (except, perhaps, those permitted under I.R.C. Section 167(k)).

3. Designated Unit Credit. The Construction Credit above, envisions a program similar to Section 236 which promotes construction of new low and moderate income housing. Should HUD choose, instead, to concentrate on utilization of existing housing or conventionally-financed new structures, a credit could be developed (a) to benefit new construction containing a specified number of low income units (which units need not be designated as such), or (b) enable owners of existing properties to designate specific units for low and moderate income use. The credit would be made contingent on the provision of a specified number of units at rents low and moderate income people could afford. A ceiling would be set on the amount of the benefit and its value it could be determined by pro-rating the number of low and moderate income units available in the development. The credit would not necessarily be attached to a housing unit. Thus, an apartment rented to a low and moderate income family might subsequently be rented to a more affluent family (or vice-versa).

It need not be implied that these three tax credit proposals be implemented simultaneously. However, although recommendations one and three may appear somewhat contradictory to one another, the former could be used to support an interim Section 236 program, while

the latter could be used to support a long term revenue sharing or housing allowance program (and the management credit could be supportive of each).

There follows a brief discussion of the 1967 Kennedy-Smathers Bill (S. 2100) and an outline of some of the reasons which tax credits are more efficient and equitable than accelerated depreciation. This Bill was designed to encourage corporations to develop low income housing in urban areas. It offered corporations an investment credit for building housing which qualified and the credit varied depending on the amount of equity the corporation invested. The minimum capital contribution was to be 20% of development costs. The larger the equity contribution, the greater the tax credit. The objective of this proposal was to encourage greater equity contributions in order to preserve the mortgage pool and thus provide more units. The tax credit was based on project replacement cost rather than the equity investment itself. The tax credit could be carried forward as much as seven years or carried back as far as three years. The Kennedy-Smathers proposal attempted to encourage corporations to invest in housing in much the same way they invest in plants and equipment.

This basic goal can still be achieved. When one compares the consequences of tax credits with those of accelerated depreciation, it seems clear that credits

offer a cleaner, more fair method of rewarding such investment. In addition credits are more flexible and provisions for carry-backs and carry-forwards can also be provided if they are deemed necessary.

Perhaps the most significant impact of the use of credits would be to increase multifamily housing investments from two major sources heretofore insufficiently tapped by the housing industry: (1) large corporate and institutional investors; and (2) lower-bracket, individual, passive investors. Tax credits have several major advantages over the existing system for corporations. The principal advantage lies in the fact that since a stock's market price is often based on earnings-per-share, corporate management avoids investments which generate tax losses (and, therefore, depress short term stock prices). While some sophisticated analysts review "cash-flow-per-share", adding back non-cash expenses such as depreciation, earnings-per-share continues to dominate. Therefore, tax credits should be far more effective in motivating corporations to invest in housing.

In addition, it has been argued that by using tax credits to induce corporate investment, the entire housing development process could be improved. Wider corporate attention could make the development and production phases more efficient. Because of their public image,

corporations might feel a responsibility to ensure that the developer, builder and manager perform their jobs well. The argument that tax credits would be preferable to accelerated depreciation methods in achieving responsible ownership is developed in a paper attached hereto as Appendix C.

The use of tax credits, rather than accelerated depreciation, would also have an ameliorative effect on individual investment. Under the current system, equity is most valuable to those individuals in the highest tax bracket. Thus, under the current system an investor in a low bracket would probably sell any interest he might own to a high bracket investor. While some sponsors are prosperous enough to make full-use of the tax shelter, most are not. Therefore, sponsors sell out to wealthy individuals who want passive investments and who need not have any contacts with the community in which the property is located. Tax credits, on the other hand, could be useful to lower income individuals who might have real ties with the community. As the following chart indicates, lower income persons could compete for these credits because tax credits treat individuals, in different tax rate categories, equitably.

Tax Rate	25%	50%	75%
Income	$20,000	$60,000	$150,000
Tax liability without credit	5,000	30,000	105,000
Credit	5,000	5,000	5,000
Taxes Due	0	25,000	100,000
Gain from investment	5,000	5,000	5,000

The tax credit would also cost the Federal Government much less since it would be targeted at an investment group with a substantially lower income than those in the 50% - tax bracket who can most effectively benefit from the accelerated depreciation provisions available under the current system. Research would determine what minimum incentives would still motivate investors to invest in residential real estate. A further advantage is that tax credits are simple and they get away from the complexities of preparing depreciation schedules and the uncertainties of complicated recapture rules.

Credits against income tax are useful to the recipient of the credit only if an income tax of sufficient size exists to absorb the credit. If not, the credit is wasted and it provides no incentive. Hence, non profit developers (religious groups, colleges, pension plans, community groups, etc.) would not receive any

incentive through the credit, though they could utilize a direct subsidy. Private developers with net losses or otherwise insufficient tax liabilities are also unaided by the credit approach.. To make use of a tax credit, developers who are losing money would have to sell it to investors and we would be in the syndication syndrome all over again. If the recent Treasury proposals are enacted, however, the developer would not be permitted to do so. Thus, all development of subsidized housing would depend on corporations or a few very wealthy developers. If they are not adequate, production of such housing would diminish sharply.

As Professor Stanley Surrey suggests in his paper (see Appendix D) these difficulties could be overcome by making the credit "refundable", i.e., payable directly by Treasury in those cases where the developer's tax liability was not large enough to absorb the credit or the developer was otherwise tax exempt.

Surrey also states that providing any form of subsidy through the tax system provides an inviting target for tax reformers. They will point to the escape from tax of the individuals involved and urge additional reform. This obstacle could be overcome by designating the credit as taxable income and adjusting the amount of the credit to keep its incentive effect at the necessary level. At

this point the credit would be equivalent in effect to a direct subsidy.

One problem with the tax credit is that the benefit only accures when the next tax bill becomes due. If we do away with interest subsidy payments and landlords are still required to reduce rentals sufficiently so that low and moderate income persons can afford them, some provision would have to be made to enable owners to overcome a cash deficit condition resulting from diminished rental income. One alternative would be to provide government loans at cost in the first year of occupancy so that owners could meet current expenses.

4. Subchapter "S" Corporations. There was another provision of the 1967 version of S. 2100 which could effectively assist in the implimentation of a tax reform program that utilized tax credits. The provision called for a revision of the rules governing Subshapter "S" corporations in order to induce groups of individuals and corporations to pool their rescurces for investments in housing. This proposal is especially important because the Administration's tax reform proposals exempt corporations from the impact of the LAL provisions. To facilitate provision of tax incentives to investors in subsidized housing, changing the rules regarding Subchapter "S" would be useful. These changes would necessarily include:

1) Permitting inclusion of more than ten shareholders, including institutional investors and corporations.

2) Removing the restriction in the "passive investment income" test to permit all gross receipts in a Subchapter "S" corporation to be derived from rents from multifamily housing.

3) Permitting Subchapter "S" corporation shareholders to include the corporation's liabilities in computing the tax basis of their stock.

4) Allowing the pass-through of capital gains without a penalty tax.

Owners electing this treatment would be able to achieve all the legal benefits of the corporate form while enjoying tax benefits similar to those enjoyed by partners in partnership entities. S. 2100 proposed to treat the Subchapter "S" corporation as a conduits between the project and shareholders in order to surmount the restriction that a shareholder's share of the corporation's net operating loss, for any taxable year, could exceed the adjusted basis of his investment in the corporation. Without this change, Subchapter "S" would be of little use to the investor, and less preferable than a partnership.

Also, S. 2100 proposed revising existing Subchapter "S" laws which prevent a corporation from using Subchapter "S" if any of its stock is held by another

corporation or trust. The obvious objective was to encourage corporations to participate as investors in the Subchapter "S" entity by permitting a pass-through of tax losses and investment credits.

These proposals should be revised in view of today's needs. We believe that the Subchapter "S" entity could be the cornerstone of a delivery vehicle through which tax credits could be made available to corporations and individuals investing in rental housing.

B. Elimination of all tax incentives

Numerous tax experts have found that the existing benefits provided to multifamily sponsors promote waste, inequality and uncertainty within the tax system. As a result, they recommend that all existing tax incentives be eliminated. Some advocate the retention of the straight-line depreciation deductions, others do not. If the Department chooses to recommend the abolition of all tax incentives for rental housing, or to allow LAL to apply to the subsidized programs (regardless of which program alternative is finally selected), it also should consider providing direct subsidies to developers in order to enable the system to continue to supply an adequate number of low and moderate income housing units. There follows a discussion of two proposals through which these subsidies might effectively be provided.

1. The Burgess Task Force Proposal

The Burgess Task Force recommended that the Federal Government set aside the existing form of real estate ownership, such as the limited-dividend partnership and the non-profit organization, and develop a new concept of ownership for low and moderate income housing. It recommended the formation of management entities, known as Housing Ownership - Management-Entities (HOMEs) which would be chartered by the Federal Government and charged with the responsibility of owning and operating the project. Under this system, before any subsidized housing project (other than a cooperative) could be proposed to the Federal Government, the builder-developer would be required to have entered into an arrangement with a HOME so that the submission could be made jointly by them. The report also proposes that all tax incentives be eliminated in regard to projects (known as "Chartered Homes") developed by a HOME together with such builders-developers, and that an ongoing cash payment be provided to the HOME for undertaking long-term ownership and management responsibilities.

The purpose of the proposal is to institutionalize the ownership/management function to enable HUD to obtain more assurance that the project is sound from the long-range management perspective as well as the short-range

development view point. HOMEs would be required to have a minimum net worth and would consist of individuals and corporations with extensive experience in running or owning rental real estate projects. The Task Force recommended that HOMEs be subject to the normal Federal corporate income tax with the exception that it be required annually to invest 1/3 of its taxable income in specified U. S. Government obligations having at least a six year maturity. The amount invested would be deductible from gross income until such time as its obligations were paid back. At that time, the proceeds would be taxable to the HOME as ordinary income. This provision would: (1) provide an increasing capital base for the HOME in order to secure performance of its obligations, and (2) provide additional incentives for persons interested in long-run business performance and growth to organize and manage HOMEs.

In the event these incentives do not prove to be sufficient and it is deemed advisable to make the operation of HOMEs more lucrative, these entities could be given Subchapter "S" status. This would permit a pass-through of their profit to the HOMEs shareholders without subjecting these profits to corporate taxes.

The HOME concept also envisions the establishment of a new developing-financing format to provide incentives

related to development, building and ownership-management with the following guidelines:

1) Instead of utilizing 90% loan-to- value ratio loans for limited dividend partnerships, the Federal Government should provide 100% loan-to-value ratio loans with staggered BSPRA payouts for projects owned by HOMEs. Elimination of the builder-developer's "paper equity" should have no adverse effect on the management of the project.

2) Basing calculation of BSPRA on 10% of a project's replacement cost does not adequately take account of the difficulty of a particular project. In the future, BSPRA for all low and moderate income housing projects of $5 million or less should be set at an unadjusted figure of 10%. For projects above $5 million, BSPRA would be reduced proportionately to an unadjusted minimum level of 5% for projects exceeding $30 million. A different BSPRA calculation would be used in those geographic areas defined by HUD as "inner city areas". In those areas the BSPRA could range from 9% to 15%, depending on the size of the project.

3) BSPRA would be viewed as a fee for developing and building and also as a fee for successful renting and initial operation of the project. Thus BSPRA should be paid out in the following fashion:

(a) 50% at the discretion of the interim lender providing the insured construction advances.

(b) 20% at 90% occupancy.

(c) 30% at the end of three years of project occupancy, provided that the project is operating substantially in accordance with its management plan and is not in default under the mortgage.

4) The project should pay an annual bonus to the HOME, above the normal management fee, after the three year BSPRA payout period had been reached. This fee would no longer be drawn from a project's cash flow but would be treated as a return on an ownership/management reserve built into the project's replacement cost. Thus, a reserve equal to 10% should be added to the replacement cost for each multifamily project. The reserved funds would be held by the Federal Government and invested.

5) The return on the reserve (plus amortization of the reserve which would be drawn from project rentals) would be utilized to pay an additional ownership/management bonus to the HOME in every year after the 3rd year of occupancy. The bonus could be set at 20% of the original equity contribution. If a HOME were having difficulty operating the project, however, it would be required to utilize this return to meet project expenses.

The "Chartered Homes" proposal suggested by the Burgess Task Force was compared to a similar Section 236 project (see Attachment A and B to Chapter IV of the Burgess Report). The comparison indicated that both per-unit rentals and government cost were reduced under the HOME format. Moreover, it provided incentives for responsible long-term ownership.

One substantial weakness of the Burgess proposal is that it is a totally integrated system based on the continuation of Section 236-type new construction and rehabilitation. Therefore, it is almost impossible to make any modifications that would provide the same flexibility that could be derived from a system of tax credits. In addition, care must be taken not to place too much emphasis on new housing which would just accelerate the deterioration of the existing stock.

2. The Wallace Proposal

James Wallace, in a doctoral dissentation for the Harward - MIT Joint Center (June, 1972) presented a more flexible proposal which was also designed to accomplish some of the same goals outlined in the Burgess Task Force proposal. Wallace points out that, under the current system of tax incentives, a developer induces high bracket investors to invest funds in the partnership in return for use of the partnership's losses. The

excess of these capital investments over the actual cost to the developer amount to an additional fee paid to the developer for his services (at the expense of the Internal Revenue Service). If allowing investors to benefit from accelerated depreciation amounts to providing the developer with compensation for his services, then a more direct approach for paying this fee outright would not only be more efficient but would avoid the administrative expenses of syndication as well as the various problems related to reliance on remote passive investors. If HUD recommended a special housing revenue sharing program, a portion of the housing funds could be specifically allocated to pay for part or all of the developers fee depending on the nature and type of housing units HUD intended to subsidize. The developers fee would be prorated in relation to that portion of a project set aside to provide low and moderate income housing. Likewise, if a housing allowance were initiated the developers fee could effectively provide a shallow subsidy to ensure an adequate supply of housing for the recipient of the housing allowance.

HUD could administer the direct fees to developers by setting regional standards that could be adjusted to reflect greater risks in central city new construction or rehabilitation. That is, urban or non-urban areas

in the same regions might require different fee schedules. Similiarly, the availability of such funds could be increased at HUD's discretion in those areas of greatest need, not just in areas where there is open land or no political opposition.

If a direct payment is not politically feasible, the developer's fees could be included in the mortgage. Since the Government is, in fact, currently paying the development fee through the tax system, the BSPRA, or whatever the developers' equity is called, could be increased to reflect the local housing market conditions and determine what is necessary to induce development in the absence of the opportunity to sell tax losses to investors. The developer's fee could then come from the mortgage proceeds dispersed at completion of construction. This proposal of providing the developer's fee through the mortgage proceeds only becomes practical under a system of Federally-insured loans to housing. Otherwise, mortgage lenders would probably be uninterested in loaning funds in excess of those required directly for the project. Conceivably, conventional lenders might be persuaded to make loans at high loan-to-value ratios, if the lender were convinced that the projected cash flow from the project was quite high and that a high market value was justified on the basis of the capitalized income expected

from the project. This is generally done by developers of commerical properties. They create a project so that the expected cash flow justifies a market value well above the cost of the project, even on a loan-to-value ratio of 75%. Although the limited dividend feature of Section 236 projects effectively diminishes cash flow distributions to investors, one of the possibilities envisioned here would allow the owner to charge market rents thereby justifying a high market value for the project.

If the developer's fee were included in the mortgage calculation, making the debt service payment perhaps 15% higher than it would be under the current system, interest subsidy payments would have to be increased so that the debt service payments could be met and the rents kept low. The proposal, however, could be adjusted to provide for another possibility. If HUD decided not to provide deep subsidies for new low and moderate income housing, it could use a housing allowance (or quasi-rent payments after having provided an initial direct subsidy to lower initial rents.

One must decide what kind of tax benefits should still be available to a developer. Perhaps mortgage interest and property tax payments should be allowed to be "expensed" in the year they occur. Other costs could

be capitalized over the useful life of the property. In all other respects, the owner would be limited to use of straight-line depreciation over the effective useful life. However, in order to avoid present problems, he would be forbidden to market any passive investment in the property. The entity having an ownership interest in this kind of assisted project would be required to assume the liabilities of a general partner before he could obtain any benefits from its development, construction, ownership, or operation.

The concept of ownership is an interesting one under these circumstances. If the total cost of all resources (including land, the developer, etc.) are covered by a combination of the mortgage loan and direct payments by the Government of the capital contributions normally contributed by private investors, one might argue that the title to the property should also belong to the Government, subject to the mortgage. Thus, in the case of no private equity contribution at all, the Government might be willing to offer the title to a qualified tenant cooperative organization at no cost. The Government, or the tenant cooperative, would then have claim to the rental income generated by the project. Any excess income could be utilized in several ways. It could be: (1) returned to the project to serve as a

capital reserve to provide for maintenance and repairs; (2) used to increase amenities within the development; (3) used as a cushion out of which to absorb increases in operating costs before any rent increases are necessary; or (4) be paid as a dividend to the tenants (either all the tenants are those receiving rent supplement assistance) for the year in which it is generated so as to reduce rents.

If a project runs into trouble in the third or fourth year of its existence, for example, HUD would receive an insurance claim in the event of a default or foreclosure. One way to alleviate this problem is to allow reasonable rent increases to reflect increases in operating costs. HUD might also be required to increase the housing allowance or rent supplement assistance to those who would otherwise be unable to meet the higher rent requirements.

This proposal is not a new one. It has been found quite successful in developing new units for public ownership under the public housing Turnkey program. In that program the developer gets his fee in a lump sum as part of the overall contract. Advantages of this proposal can be seen in terms of administering housing policy more directly. There would no longer be designated subsidized projects. A cross section of income groups would be able to live in the same housing development.

The filtering process would be facilitated by providing incentives for middle and moderate income families to move into new units.

C. Revising Existing Tax Law Provisions Relating to Multifamily Residential Real Estate

Critics of the current tax benefits have called for a total reformation of the tax incentive system. Some, like Professor Surrey, seem to think that the use of any tax incentive system is wasteful; others believe that a different combination of incentives might be more beneficial. The purpose of this section is to outline some thoughts concerning a fairly dramatic restructuring of the Internal Revenue Code. The proposal is designed to provide a construction incentive as well as a management incentive to developers/owners of multifamily housing. In this connection we have determined that true tax shelters only arise where non-cash deductions exceed non-deductible cash outlays. Thus, with respect to rental apartments, the excess of depreciation over non-deductible amortization of principal constitutes a true tax shelter. Most other items such as prepaid interest and the deduction for interest and taxes during construction, do not constitute true tax shelter items because they do not constitute accounting losses and, in fact, represent actual out of pocket expenses.

The following is a new approach to Federal taxation of residential rental real estate:

(1) All out of pocket construction costs, including those not currently deductible, (but not costs paid out of funds obtained through construction or permanent loans) would be depreciable over a very short period of time. Instead of the 25 to 50 year useful lives now used, a five year useful life might be used.

(2) All ordinary and necessary business expenses such as management fees and legal and accounting fees and other currently deductible items, such as taxes, interest and the like, would be deductible when paid or accrued, provided no more than one year's prepaid costs could be deducted in the year incurred.

(3) Since the mortgage would no longer be part of the basis, and would not provide deductions in the same manner as would out-of-pocket construction costs, the amortization payment (which currently cannot be deducted) would become deductible in the year the expense is incurred. This would require revision of the Internal Revenue Code which now treats amortization payments as non-deductible return of capital.

(4) With respect to all new capital costs incurred for the reconstruction, rehabilitation and substantial improvement of rental residential real estate, the cost of any items, which currently could not be "expensed", would be depreciable over a shorter time period (e.g. five years).

(5) Standards would also be set for management fees by establishing a "reasonableness" test for allowing their deductibility. To the extent they exceeded a reasonable level in a given year, the excess would be added to the amortizable basis of the building.

(6) A strict recapture provision would provide that any gain in property value resulting from a sale would be treated as ordinary income until the 22nd year following completion of construction, at which time it would be treated as a capital gain. This would provide a strong incentive for owners to keep and maintain the property because the owners' basis would be zero after five years and an early sale would result in a substantial tax liability.

The foregoing is based on two premises. First, there should be an incentive to new construction by providing a very fast write-off for all costs incurred in construction. In Canada, for example, where incentives are needed to cause new construction in undesirable areas, costs are depreciable over as short a period as one year. Second, the present useful life tables provide no real incentive to construct new buildings because deductions for depreciation are spread over such a long period of time. To offset this, management fees, rent-up fees, and other incentives have been devised. It would be simpler to shorten the useful lives, thereby eliminating the need for other benefits.

A current source of controversey with respect to real estate is the use of the non-recourse (no

personal liability) mortgage (also known as a purchase money trust deed). The above proposal would eliminate the non-recourse mortgage, but allow deduction of payments for the amortization of principal. This deduction, coupled with use of shorter useful life, would increase the incentive to hold newly constructed buildings throughout the mortgage term. Of course, there are some problems with this proposal. First, it may turn out that such reliance is placed on the non-recourse mortgage that participation would drop sharply. Second, it envisions a substantial revision of the Internal Revenue Code, including Sections 162,163, 164, 266, all Sections pertaining to interest deductions and loan repayments, all Sections pertaining to recapture and basis (1201, 1212, 1221, 1231, etc.) If such a revision were feasible, it should be the subject of extensive research.

We therefore, find the recommendation dealing with tax credits the most reasonable and practical approach available.

V. Recommended Tax Policies to Complement Proposed Housing Alternatives

The following are recommended tax policies for various housing alternatives currently under consideration by Housing Policy Team IV. Specificially, tax policies are transmitted for the following: Revenue Sharing; "Tinkered" S236; Housing Allowances; Burgess Task Force Recommendations; No Subsidy.

A specific discussion relating to an income maintenance alternative is not included because the basic subject is being developed by HEW and the details are not available.

The tax policy recommended with respect to each alternative will relate primarily to the production of multi-family rental housing for persons of low and moderate income, unless otherwise stated.

REVENUE SHARING

Financial Characteristics

Under this alternative, the Federal Government would distribute tax revenues to State or local public bodies which would redistribute that money to encourage, in part, the development of rental housing for low and moderate income persons. As of yet, the extent of control on the redistribution of Federal revenues is unclear. To the extent that there are criteria or standards, and the constraints take the form of program alternatives that HUD would have adopted but for adoption of reveune sharing, tax policy should be the same as if HUD had directly implemented the housing program.

Tax Policy

There are two tax policy alternatives that might prove compatible with this program alternative. The first assumes that the revenue sharing payment will equal the total subsidy currently available through HUD and the tax system. If so, HUD should:

1. Support LAL. The effect of LAL is to take away the tax benefits of accelerated depreciation and require taxpayers to use straight-line depreciation. This should include support for the provisions which define artificial accounting losses to include construction period items (interest, taxes and other carrying charges) and which

characterize accelerated depreciation of rehabilitation expenses as an artificial accounting loss.

2. Eliminate accelerated depreciation - as above; but retain straight-line depreciation for all rental residential real estate.

3. Substitute an investment credit (or other system of credits) for non subsidized projects so that rents can be kept reasonable.

A second, less desirable, alternative would be to:

1. Support LAL and continue the existing tax incentives, e.g., accelerated depreciation, expensing construction costs, recapture, etc. for non-subsidized projects.

2. Provide a lower revenue sharing payment. States would provide a shallow subsidy for housing for moderate and middle income families. Hopefully, "filtering" would work to assist low and moderate income families.

A HOUSING ALLOWANCE PROGRAM:

Financial Characteristics

A housing allowance is designed to enable eligible recipients to rent or purchase housing of their own choice. It could to to any head of household as a direct cash grant equal to the difference between 25% of adjusted income and the cost of adequate housing and could be used to rent or purchase any existing standard housing. It could, of course, have different characteristics.

Tax Policy

If HUD adopts a housing allowance program, certain tax policies could also be adopted that complement and facilitate the implementation of the housing allowance system. The following paragraphs outline some recommendations:

1. Payments Non-taxable: The enabling legislation for the housing allowance program should contain express language to the effect that amounts received by a taxpayer for housing allowances are not treated as taxable income. Before implementation of the existing experimental housing allowance program, HUD obtained a private ruling from the Internal Revenue Service that such allowances were not taxable income because they were not received in return for services. To assure uniformity, if the housing allowance system is put into national operation, HUD should

obtain specific legislation consistent with all other tax policies based on need.

2. Modify LAL: As previously discussed, the Treasury Department's "Proposals for Tax Change" submitted on April 30, 1973, contained various provisions including the Limitations on Artificial Accounting Losses (LAL) which applied to the amortization of rehabilitation housing expenses in excess of straight-line depreciation Section 167 (k). If HUD initiated a universal Housing Allowance program then the need for accelerated depreciation and other tax benefits disappears because the market will establish r reasonable rentals for specific units. A limited housing allowance program, however, requires the availability of adequate existing housing. HUD should therefore, seek to modify the LAL proposal and exclude from the definition of artificial accounting losses the accelerated depreciation permitted by Section 167 (k) of the Internal Revenue Code.

3. Tax Credit for Rehabilitation: Still assuming a limited program, regardless of whether HUD is successful in excluding accelerated depreciation on rehabilitation expenditures from the operation of LAL, HUD should seek enactment of legislation

expressly designed to stimulate the rehabilitation and the long term maintenance of existing housing. Such legislation could take the form of a tax credit on expenditures for rehabilitation of existing residential real estate for which housing allowance payments are utilized. The retention of existing Section 167 (k) of the Internal Revenue Code is recommended to complement this tax policy.

4. Full Deductibility: If the recipient of a housing allowance is permitted to use the subsidy to purchase housing, recipients of the housing allowance should be entitled to deduct amounts paid for property taxes and mortgage interest to the same extent as are other homeowner taxpapers. This would be consistent with tax law which permits owners of Section 235 units to deduct mortgage interest even though it is paid, in large part, by the subsidy. Similar treatment should be accorded property taxes. To the extent there are any changes in overall deductibility of mortgage interest and property taxes by all homeowners, such changes should also apply to recipients of housing allowances. If part of the definition of "economic rent" under a Housing Allowance program includes property taxes, interest, maintenance expenses, etc. and adjustments are made by locality such a credit is uneccessary.

5. Tax credits for Excessive Property Taxes:

Otherwise, to assure that recipients of housing allowances do not pay property taxes disproportionately high in relation to their income, HUD should adopt a tax policy that offers recipients of housing allowances an income tax credit for payment of "excessive" property taxes. Treasury's reform proposals contain a proposal for a property tax credit for the elderly. In enacted, recipients of housing allowances should be included. The credit could be allowed for real property taxes in excess of 5% of household income, subject to the same 5% floor and $500 maximum. For this purpose, renters should be considered to have paid real property taxes, in part from the proceeds of a housing allowance, in an amount equal to 15% of the rent paid. Since the housing allowance itself would have certain income limits to determine eligibility, the property tax credit would primarily aid low income and middle income persons.

Oppose LAL: In many areas, a housing allowance system, to be effective, requires an expanding supply of available standard housing. Therefore, HUD should request tax laws that provide for a construction credit to promote new residential multifamily development, coupled with designated unit credit so that property owners will have an incentive to rent to low and moderate income persons. This approach means general opposition to the Treasury's LAL proposals in as much as LAL discourages investment in real estate.

A TINKERED SECTION 236 PROGRAM:

Financial Characteristics

The discussion below assumes that a modified Section 236 program will have the following major characteristics: (1) an insured mortgage; (2) total subsidies comparable in amount to the present program, but with greater flexibility in application of subsidies to a wider range of incomes; (3) a tax credit to builders in the range of 4% to 6% of development costs (4) a tax credit for owner-managers to partially defray the costs of operating and maintaining the 236 project; (5) a limitation on cash flow distributions. Only those modification which have income tax consequences are discussed below. A paper discussing these and other modifications of Sec. 236 has been prepared by Dale A. Whitman of Team IV.

Tax Policy

If HUD modifies the Section 236 program as above, we recommend that the following tax policies also be adopted:

1. Support LAL: If tax credits for operation and construction are made available in sufficient amounts to make building and ownership of Section 236 housing an attractive investment, (a question that cannot be answered until the tax credit formulas are determined) then HUD should support the proposed tax changes submitted by the Treasury, including the proposed LAL; it would be feasible to go even further

167 (k) rehabilitation expenses;

d. set a definite time limit on the application of the LAL proposal, for example three years, so that its effect on real estate investment may be evaluated.

As an alternative to tax credits for Sec. 236 builders, it may be desirable to make direct government grants for 236 construction. The enabling legilation which creates the construction grant program should describe the tax consequences of that grant. Specifically, the legislation should indicate whether the grant is considered taxable income to the receipient and whether the taxpayer may consider grant funds in establishing his basis for the property. It is recommended that the legislationexclude the grant from income and that the taxpayer be permitted to depreciate the total cost of the Section 236 project, including those costs which grant funds helped to pay. If Section 236 projects are not subject to LAL, the ability to take accelerated depreciation or credits on a basis that includes the construction grant can improve the rate of return on the investment--depending on the size of the grant. Even if HUD supports LAL, since straight line depreciation is still permitted, the effect of the construction grant on the taxpayer's basis must be considered.

and limit projects to straight-line depreciation. This is appropriate because if the 236 project receives sufficient tax credits so that the developer can obtain an adequate rate of return on his investment, he does not need the added financial benefits obtained through the syndication of tax losses to passive investors.

2. Modify LAL: If tax credit formulas do not yield an investor a competitive rate of return from net rental income, HUD should oppose the LAL provisions of the Treasury proposal as it relates to the Section 236 program, and should support the continuation of the existing incentives.

Section 167 (j), permitting accelerated depreciation for new residential real estate and Section 167 (k) permitting the five-year wiritoff for rehabilitation would not be altered. Thus, HUD should press for the modification of the LAL proposals as follows:

a. a complete exception for residential real estate that receives assistance from the modified 236 program;

b. amend the definition of artificial accounting losses to exclude pre-opening expenses;

c. amend the definition of artificial accounting losses to exclude depreciation of Section

BURGESS TASK FORCE RECOMMENDATIONS

Financial Characteristics

The Burgess Task Force recommendations on multifamily housing for persons of low and moderate income included:

1. Creation of a federally chartered entity (called a Housing Ownership-Management Entity-HOME) which would own and manage multifamily low and moderate income subsidized housing.
2. Each subsidized multi-family project would be owned by a separate subsidiary of the Home and stock of the subsidiary would be pledged to HUD to enforce the commitments of the subsidiary.
3. The "HOME subsidiary" would be directly responsible for the development of a specific project and would receive a shallow-subsidy. The subsidy would be based on the difference between Federal borrowing costs and long-term private mortgage financing costs, either with or without the application of Federal insurance. Units in the project would also receive "housing opportunity allowances" aimed at lowering housing costs to fit the incomes of the communities in which the projects were located.

Tax Policy

The recommendations of the Burgess Task Force carry with them specific recommendations with respect to Federal income tax policy. Notwithstanding a general distain for

tax incentives, several recommendations concerning tax and the Burgess recommendation are reported below. Our analysis also contains a policy recommendation relating to the Treasury's reform proposals:

1. Taxation of a HOME: A HOME, according to the Burgess recommendations, would be subject to the normal Federal corporate income tax. It is also recommended that there be a special deduction for investment of one third of taxable income in specified U. S. government obligations having at least a six year maturity. If HUD were to adopt the Burgess recommendations generally, HUD should also adopt the tax recommendations, including the suggestion that all HOMEs be Subchapter S corporations. The enabling legislation for the creation of federally chartered HOMEs should contain the legislation required to carry out the tax recommendations.

2. Nontaxable HOME Subsidiary: The Burgess Task Force recommends that: "A HOME Subsidiary would be a nontaxable entity. It would not be subject to tax on any income it might realize. Any losses realized by a HOME Subsidiary would not be subject to offset against the income of its parent or any other entity." (IV, 6.)

This policy is sound and should be adopted by HUD in the event Burgess recommendations are generally adopted. Enabling legislation creating the HOME should state that so long as a HOME subsidiary distributed all profits to the parent, it would be liable for no Federal income taxes. Separate provisions limiting the ownership of a HOME subsidiary would prevent the subsidiary from selling tax losses.

3. Support a Modified form of LAL: If the Burgess recommendations, were adopted, HUD should support the "Proposal for Tax Change" submitted by the Treasury and the provisions regarding LAL. However, unless rehabilitation projects are to be undertaken by HOMES, it is recommended that HUD press for a modification of the LAL definitions to exclude from the definition of artificial accounting losses the accelerated depreciation for rehabilitation expenses authorized by Section 167(k).

NO SUBSIDY

Financial Characteristics

If HUD decides that no subsidy program (except mortgage insurance), should be used to stimulate the construction of housing for persons of low and moderate income, there are nevertheless certain tax policies that could make the mortgage insurance program more effective. It is assumed, however, that mortgage insurance will be available only to developers who provide housing at rents within the financial means of low and moderate income persons.

Tax Policy

As a general proposition, if HUD offers only mortgage insurance, no tax policy can stimulate the construction and rehabilitation of housing in the same manner as direct Government subsidies. In fact, it would be a misuse of tax laws to provide indirectly that which HUD should do directly. Tax laws designed to replace direct housing subsidies could also result in revenue agents creating and administering housing policy. Nevertheless, there are certain limited tax policies HUD could adopt which would complement a housing policy based predominantly on mortgage insurance:

1. Modify LAL: Without direct HUD subsidies, real estate investors need a very strong financial incentive to produce dwellings for persons of low- and moderate-income. The use of accelerated depreciation to shelter project and other income is one such financial incentive that gives

marginal investments substantial after-tax profits. Even under a housing policy that provided only mortgage insurance for rental units designed to house low and moderate-income people, the need for accelerated depreciation to improve financial performance (including accelerated depreciation of investment in rehabilitation projects) becomes almost essential. Therefore, the "Proposals for Tax Change" offered by the Treasury Department, and particularly those provisions relating to (LAL), would have to be modified to preserve the approach (enacted in 1969) which has proven effective in stimulating investment in selected types of housing. The modifications in LAL that HUD should recommend include:

a. An unlimited exception form LAL for HUD-insured projects which benefit persons of low and moderate income;

b. A change in the definition of artificial accounting loss to exclude the construction period interest, taxes and carrying charges costs which are not artificial;

c. A change in the definition of artificial accounting loss to exclude accelerated depreciation of rehabilitation expenses, a provision that has stimulated practically all the investment in central city rehabilitation since 1969; and finally,

d. A definite time limit, for example three years, on the effect of LAL in order to evaluate its

impact on real estate investment in general.

2. Tax Credits for Insured Projects: The Treasury "Proposals for Tax Change" place investment in real estate at a competitive disadvantage to investment in oil and gas exploration. Under the proposed Treasury Exploratory Drilling Credit, intangible drilling costs for domestic exploratory holes are entitled to a 7% investment credit. If the exploratory holes proves commercially productive, a supplementary credit of 5% of intangible drilling costs would be allowed against the first tax payable on net income from productions. This favoritism of the oil and gas industry over housing should be opposed by HUD. Investment in designated housing, (for example, housing that receives a HUD mortgage insurance commitment) should be eligible for a direct tax credit for that investment. This tax incentive should be in addition to, and not in place of, the tax incentives provided by accelerated depreciation, limited recapture, and general exclusion of HUD insured projects from the operation of the LAL proposal. The tax credit for investment in designated housing would be an additional tax incentive (specific details are described, infra). The important point is that real estate investment should be at least at parity with investment in oil and gas exploration. A tax credit, available in the year of investment, when contrasted to other forms of tax incentives, is more simple and easy to understand. Yet, since available only in the year of investment, it is not reason-

able to rely on this tax incentive to increase substantially the flow of investment dollars in rental housing for low and moderate income families under the investment has income tax consequences for a 30 to 40 year period.

Appendix A

Housing and Income Tax Subsidies

ABSTRACT: This report inventories and evaluates existing direct and indirect tax subsidies for single and multifamily housing.

Discussion Draft No. 2 Date 6/22/73

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.OUSING AND INCOME TAX SUBSIDIES: A REPORT TO THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

by Paul Taubman

In this report I will inventory the existing direct and indirect tax subsidies to single and multifamily housing. Given the short time span in which this report has to be prepared, I find it necessary to forego certain technical proofs, delightful though they are, and to rely on citations to appropriate references. It is necessary, however, for certain definitions to be set forth at this time.

1. TAX SUBSIDIES AND OTHER DEFINITIONS

The recent JEC volume on tax subsidies [1] has indicated the conceptual difficulties in establishing an all inclusive definition of "subsidy." Tax subsidies, however, are easier to define. According to both an "ability to pay " and economic efficiency approach, a person (or firm) is granted a tax subsidy if his tax payments are less than those of another person with the same "economic" or true income.[1,2] Tax subsidies, therefore, reflect lower tax rates for certain persons or types of transactions or a tax base that is less than economic income.

In this report housing will be defined in terms of quantity or number of units of a standard type and quality. Quality will include such

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[1] In this paper I will assume that income and not consumption or wealth is the agreed upon tax base unless specifically stated otherwise. In the definition I am also ignoring possible adjustments for differential risk bearing.

[2] Economic income is defined as consumption plus the change in net worth.

things as the condition of the building shell and the range and type of equipment and other services provided in supplying shelter. Single family will stand for owner occupied, and will include condominiums and mobile homes, while multifamily will mean rented housing. Indirect tax subsidies are those granted to mortgagers or suppliers of raw materials used in constructing houses and which result in a reduction in the market cost of producing housing services.

At some points we will be concerned with low and moderate income housing which are defined as housing whose costs are such that people with certain specified levels of income can afford the mortgage or rent payments.

2. AN INVENTORY OF DIRECT TAX SUBSIDIES TO RENTAL HOUSING

The current tax law provides a variety of direct tax subsidies to housing. An excellent summary of most of these can be found in Slitor [2], some of whose details have been outmoded by changes in the 1969 and 1971 Tax Acts, and in Aaron [3].[1]

Table 1 lists these subsidies separately for owned and rented houses. In this table and subsequent discussion I have not included certain programs that are only available to small groups such as farmers or veterans. See Aaron's appendix for these [3]. The first item on the list for rented housing, too rapid depreciation of the building, is most important by itself and also plays a key role in magnifying the tax subsidies inherent in items 2, 3 and 4. Because too rapid depreciation is so important, it is necessary to consider in detail what we mean by "too rapid" and what depreciation system would be just right.

Too Rapid Depreciation

Nearly all tax depreciation systems allow the tax payer to write off the value of his investment or the cost of the asset during the asset's life.[2] But as has been shown rigorously by Samuelson and demonstrated numerically by Taubman and Rasche [4], a tax system will confer a subsidy if the present discounted value (PDV) of the tax depreciation exceeds that of the PDV of the stream of annual losses in value.[3]

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1 The 1971 and 1969 tax Acts made important changes in the treatment of housing. We use these provisions though buildings purchased before these dates have even more preferable treatment.

2 Below we consider the effects of mortgages which form a wedge between the owner's equity and the cost of the investment.

3 If the opposite occurs, the tax system imposes an excise tax on the asset.

TABLE 1

DIRECT TAX SUBSIDIES FOR OWNED AND RENTED HOUSES

Multifamily Housing

1. Too Rapid Depreciation on Building
2. Capital Gains Treatment of Certain Transactions and Limited Recapture
3. Depreciation Base Too Large
4. Tax Free "Exchanges"
5. Too Rapid Depreciation of Equipment
6. Noncomparability of Treatment of Expenses and Revenues
7. Tax Free Transfer Payments

Single Family Housing

1. Imputed Rental Value Tax Free
2. Interest and Property Taxes Deductible if Itemized
3. Capital Gains on Sale
4. Tax Deferral on Capital Gains
5. Capital Gain Exemption for those who are more than 64 years old

For Both Types

1. Exemption from Corporate Tax

this true or economic depreciation should also be included in determining economic income on page one, footnote two. Or, in other words, if the tax payer is allowed to write off an asset too quickly, he in effect receives an interest free loan from the government in the form of postponed taxes.

The definition is clear, but the factual question of the age pattern of economic depreciation still remains. Since 1971 the tax code allows investors to use the double declining balance depreciation formula on new buildings and 125% on used residential buildings. (These will be defined below.) Most readers of this report will have heard enough stories about double declining balance (or related methods) which allow (accelerate) deductions faster than that allowed by straight line, to be convinced that double declining balance is too rapid.[1] There is available some firmer evidence on the pattern of true depreciation. First, based on published data on rents and costs, Taubman and Rasche [4] have calculated that true depreciation is much slower than even straight line. While their exact results vary by year and are somewhat sensitive to certain assumptions, they always find that for each of the first 40 years of useful life--the average tax life of shell and equipment--the true annual loss in the value of the building is less than that allowed by the straight line formula with a 40 year useful life. Second, even in the early 1960's when inflationary expectations were very small, it was possible for investors

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[1] Straight Line Depreciation allows an annual deduction equal to (1/N) times Cost where N is the useful life of the building or 40 years for apartment buildings. Double Declining Balance lets the person write off in each year an amount equal to 2/N (Cost - Previously Accumulated Depreciation). The person also can switch to straight line for the remaining life and undepreciated balance whenever he wishes. As shown in [4], the optimal time will be in n/2 years.

to receive close to 100%, 15 year mortgages on new apartments. Thus banks and life insurance companies must not have expected much loss in value over this time span during which the tax laws let the investor write off 3/8 of the cost of the building with straight line methods or more if accelerated depreciation formula are used. Thus it seems that not only are the permissable tax depreciation rules--double declining balance on new residential buildings, 125% on used--a subsidy, but so is straight line depreciation. Indeed, Taubman and Rasche conclude that true depreciation is approximated by reverse sum of the years' digits.[1]

There is one special rapid depreciation system for low income housing. Section 167k permits the taxpayer to amortize certain expenditures on repairs undertaken to rehabilitate low income housing over a five-year period (with salvage value set at zero) as long as the useful life is at least five years.[2] This provision expires in 1975. While I know of no study that has examined the pattern of true depreciation on such repairs, the economic life of the repairs may be 10, 15 or more years, and salvage value will often be positive. Hence it seems clear that, as intended, a tax subsidy is granted by this provision.

Captial Gains and Limited Recapture

The Tax Code currently allows 1/2 of (long term) capital gains to

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[1] The sum of the years' digits method allows a deduction in year t of $(N-t) / \sum (N-t) = 2(N-t)/(N+1)N$. Reverse sum of the years' digits is equal to $2(N-(N-t))/(N+1)N$.

[2] To try to make sure that rehabilitation occurs, at least $3,000 has to be spent during two successive years, while to restrict the subsidy to low income housing no more than $15,000 per unit is granted this treatment. Also qualified investment is to be defined by HUD standards.

e excluded from the tax base.[1,2] Thus the maximum tax rate is only 1/2 of that on ordinary income and there is, accord.ng to our definition, a tax subsidy.[3] As noted above, the special treatment only applies to "long term" gains. While the general rule in the Tax Code is that an asset passes from the short to long term status after being held for six months, there are some special features for residential rental properties.

Since 1969 all depreciation on such investments are subject to a "recapture rule." This rule states that until a property is held for at least 100 months that portion of the difference between the sales price and the tax basis (i.e. original cost less accumulated depreciation taken on tax returns) that represents excess depreciation is not granted capital gains status but is taxed as ordinary income. Excess depreciation is the cumulated difference between accelerated and straight line depreciation. In other words, the tax law "recaptures" all of the excess depreciation in the first 100 months. However, for each month that the property is held beyond 100 months, an additional one percentage point of the excess depreciation is treated as a long term capital gain and not ordinary income.

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1 It is sometimes argued that capital gains are due to inflation which results in a tax on capital and not income. This argument is evaluated in the homeowner section.

2 The first $50,000 of long term capital gains from all sources are taxed at the lesser of half the ordinary income tax rate or 25%. Capital gains in excess of $50,000 are taxed at half the ordinary rate. The maximum rate on ordinary income is 70%.

3 However, the half of capital gains not taxed is subject to the minimum tax provision.

Thus the complete holding period before a gain is considered is 16-2/3 years.[1] Several points must be noted about this recapture rule. First, even when the taxpayer sells the building before the 100th month and is subject to full recapture, he has still received the substantial advantage of an interest free loan from the government by deferring tax payments for up to 100 months. Second, and probably more important, the "excess" depreciation subject to recapture is only the cumulated difference between straight line and the more accelerated method used. Yet the above discussion indicated that there is some evidence that straight line depreciation is too large. Finally, the capital gains treatment is still granted to that amount of the difference between sales price and tax basis that exceeds excess depreciation. Such capital gains can arise because of increases in site value, good management, or even lower mortgage rates.

Depreciation and Borrowed Funds

The depreciation and capital gains subsidies are conferred on the owner of the property with the statutory amount of the subsidy determined by the cost of the property. The dollar amount of the subsidy is the same regardless of the distribution of the financing of the project between debt and equity, but the full subsidy is paid to the provider of the equity.[2] A 1% subsidy based on the original cost paid to someone who actually invests 1% of the price--a situation that does occur--is a 100% subsidy

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[1] Given our "ability to pay" definition of a subsidy, it is worth noting that currently the excess of accelerated over straight line depreciation for all other assets is always subject to recapture whenever a business asset is sold for more than the tax basis.

[2] Of course the subsidy can be shifted to the debt financer through higher interest rates.

his investment. If the tax law only allowed economic depreciation, then no subsidy would arise from letting the owner depreciate the total original cost of the asset since the decrease in his net worth is a reduction in his ability to pay. While a taxpayer can increase the value of the subsidy from too rapid depreciation by using debt financing, the subsidy arises from the excess depreciation and not from the too large depreciation base.

Tax Free Exchanges

Capital gains (and the possible recapture of excess depreciation) are only recognized when the gain is "realized". Realization generally requires the sale of the building. There are, however, some sales or transactions on which the taxpayer is not considered to have realized the gain and thus is not subject to tax. Tax free exchanges include: swaps for a like kind of asset; contributions in kind to universities and certain other charitable institutions; remortgaging of a building; bequests at death; and involuntary conversions.

Section 1031 allows certain types of swaps of the same assets. Since, however, these swaps do not have to be for assets with the same tax basis, or market value (since cash can be added), it is possible for the person to acquire a more valuable asset without paying the tax on the old property, but continuing to use its basis for the new property.

A taxpayer can itemize as a deduction up to 30% of his adjusted gross income of contributions in appreciated assets made to certain charities. The deduction is for the current market value of the asset, but the contributor need not realize the gain on these assets. If a taxpayer were going to sell the building in any event, he can actually make a net profit

by giving it to charity. For example, if his tax basis is zero and he is in the 70% tax bracket, a $100,000 sale would yield him $65,000 increase in his disposable income after paying his capital gains taxes.[1] But, if he donates the building, he can reduce both his taxable income by $100,000 and his taxes by $70,000 (if he does not exceed the 30% annual limit). In other words, his after tax disposable income from giving the building away is $70,000.

Another, perhaps quantitatively more important means of achieving a tax free transfer is via remortgaging. Suppose at the end of 15 years, a person has repaid his original mortgage. Further, suppose that he has written off 50% of the original price of the asset but that its true value has declined by only 10%. He can obtain a mortgage on all or part of this 90% at a mortgage rate of say 7% which is deductible against his ordinary income (at regular tax rates), but reinvest all the mortgage proceeds in tax free or subsidized assets such as municipal bonds or residential properties.

When a person dies and bequeathes an asset, his heirs are allowed to use the true market value at date of death (or a year later) as their tax value but the deceased is not considered to have realized any income from their step up in basis. In other words, any unrealized capital gains--including those connected with excess depreciation--are not taxed as income though like all other assets, residential properties (at market value) are subject to an estate tax.

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[1] However the recapture rule for excess depreciation applies.

When insurance or condemnation awards exceed the tax bases, the owner can defer paying a capital gains tax if he invests in a "like kind" property within a year or other specified period.[1] It is debatable if this should be treated as a tax subsidy.

Under provisions of Section 453, when the proceeds of a sale are spread over several years and the sale qualifies as an installment contract, the taxpayer need only include in his annual income the proportion of the gain equal to the percentage of the eventual total payments actually received in that year. Alternatively for a deferred payment sale, the taxpayer need not report the gain until payments received exceed the tax basis. Under both methods the tax payment is deferred and it is possible to spread the gain and thus for the taxpayer to be in a lower tax bracket than if all the gain were taxed in one year.

Finally, for section 236 housing, there are certain conditions, described as rollover, under which taxes of capital gains on a sale are deferred.

Too Rapid Depreciation of Equipment

Buildings do not receive either the investment tax credit or the subsidy of too short lives contained in the Asset Depreciation Range System (ADR).[2] But housing services or shelter are provided by equipment

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[1] See Section 1033 of the IRS Code.

[2] For a discussion of each see [5] and [6]. Roughly the tax credit rebates a portion of the purchase price of the asset as a tax credit with no reduction in the depreciation base. The ADR section sets a useful life that generally corresponds to that life used by the firm at the 30th percentile of useful lives (with the firm with the shortest life first) rather than average life used.

s well as a building shell; the equipment (including elevators, escalators, and appliances) installed in a building receives these subsidies. In addition equipment is eligible for accelerated depreciation, but I know of no studies which indicate whether building equipment depreciates this fast or not.

Noncomparability of Expenses and Revenues

The general economic, accounting and tax procedure is that expenditures should be offset (amortized) against the revenues they generate and that both should be accorded the same tax treatment under the tax laws. It is possible, however, to write off certain repair expenditures in the year when made though these will generate revenues in the future. Such instant deductions of depreciable expenditures probably occur because of the difficulty of isolating and determining the items involved.[1] Alternatively it is possible to upgrade an apartment building through painting and other maintenance items and then sell the building. The maintenance expenditures can be offset against ordinary income, while the revenues generated from the expenditures are treated as a capital gains and taxed at half the ordinary rate. Also it is possible for firms which construct and operate buildings to expense certain construction costs rather than capitalizing and later depreciating them.

Tax Free Transfer Payments

At least brief mention should be made of the whole gamut of subsidy programs in which renters receive accommodations which have a market value

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[1] Expenditures on major improvements, when identified as such, are depreciated over their useful life.

more than the rent they pay.[1] The excess value--in public housing or rent supplement plans--to the recipient constitutes income to the individual which is not subject to the income tax.[2]

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[1] See Aaron [3] for a list.

[2] Eligibility for the programs and the excess value received may be affected by levels of income.

3. DIRECT SUBSIDIES TO OWNER OCCUPIED HOUSING

Implicit Rents, Property Taxes and Interest Payments

Owners who occupy their own home receive a somewhat different set of subsidies. Conceptually a homeowner can be thought of as a businessman who rents to himself. Under this view, the homeowner should be taxed on his business profile which would equal the rentals that could be charged less appropriate costs of doing business. These costs would include mortgage interest and property taxes.[1] In fact the tax allows those taxpayers who itemize to deduct mortgage interest and property taxes but does not include in the tax base any estimate of implicit rents. The combined treatment of these deductions and of rents constitutes a tax subsidy.

It is sometimes argued that property taxes on residential properties are improper or unfair. Hence, it is also concluded that the current income tax treatment is necessary to offset the unfair tax. The fairness of any particular tax base is an important question but not one that economists have any special expertise in answering. However the conclusion is not valid. First of all communities use the property tax to provide services to residents and if the tax is too high relative to the services, many people have the option of moving to another community or voting for different leaders. Second, even if the tax is so high that people suffer a net loss (on their imputed income less cost of providing services) only this loss should be deducted from income.[2]

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[1] There are various other costs such as utilities and gardening, but since these would also increase rent, they would not change profits and can be ignored.

[2] Aaron [3], however, indicates that on average people receive a net profit from their own home.

Capital Gains Treatment

The difference between the original purchase price (plus improvements) and subsequent sales price is taxed as a long term capital gains (after being owned for six months), which as noted earlier is considered to be a subsidy. However, for owner occupied homes and indeed for most assets, it has been argued that the capital gains treatment is not a subsidy but a necessary and proper offset to the "unfair" tax arising from inflation. The essence of this argument is that the increase in sales price over original cost represents a general price increase and that only changes in the real (constant dollar) purchasing power sould be included in the tax base. There is substantial merit in the argument that only increases in real purchasing should be treated as taxable income, but fairness and logic require that such a theory should be extended to all assets and liabilities. At least in the case of an unanticipated inflation, the homeowner and owner of residential rental properties receive a capital gain from paying off mortgages with "cheap" money. Since owned and rented residential properties usually require down payments of less than 25% and often about 10% or less, the inflation argument does not seem very important.[2]

Deferment of Capital Gains Taxes

In the U.S. capital gains taxes generally are levied only when the gain is realized by a sale (or other transaction). There are several situations, however, when the capital gains tax on owner occupied housing

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[1] Deferment of the capital gains tax is discussed below.

[2] And less important than for most other types of assets which are less financed by debt.

an be deferred for many years or forever. As with accelerated depreciation, the postponement of the payment of a tax confers an interest free loan or a tax subsidy. Under section 1033, a taxpayer who sells one house but buys another residence within 12 months, does not have to pay capital gains tax to the extent that the price of the new residence exceeds the sales price of the old residence. (However, for tax purposes, the basis of the new residence is the basis of the original house.) The taxpayer can use section 1033 on each subsequent sale. As with rental housing, the tax is deferred if an involuntary conversion was the source of the gain and if the homeowner buys a like asset.

Forgiveness of Capital Gains Taxes

In at least two instances the taxpayer can avoid the capital gains tax. First, if the person dies, the Tax Code does not consider "realization" to have occurred and no income tax is levied. (The deceased's share of the house at current market value is included in the estate tax base.) Second, under Section 121, individuals aged 65 or over do not have to pay taxes on gains on houses if the house's adjusted sales price is no more than $20,000 (with partial exemption if the price exceeds $20,000) and if the house was used as the homeowners residence for five of the eight previous years.[1]

Transfers Not Taxed

There are several subsidy programs (including NHA section 235) which reduce mortgage payments either through guarantees or through government payment of part of the interest. As in the case of rental housing, the value of these subsidies are not included in the income tax base.

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[1] On all these deferment and forgiveness provisions, there are technical rules concerning tax basis and adjusted sales price. See Slitor [8].

The Corporate Tax

Most business assets are owned by corporations who are subject to the corporate income tax.[1] Owner occupied and most rental housing are operated by individuals and partnerships. Harberger [7] has pointed out that since corporate profits are also subject to the individual tax when distributed, owners of both types of residential property pay less tax than owners of corporate assets with the same ability to pay. Thus housing receives a subsidy vis a vis other assets. While in principle he is correct, the issue is much more complicated because many residential properties are owned by people in the 70% tax bracket who, in the absence of tax subsidies, could escape taxes by incorporating and retaining earnings.

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[1] Closely held corporations can elect to be taxed as partnerships under subchapter S.

4. INDIRECT TAX SUBSIDIES TO HOUSING

The cost of housing depends on the price of raw materials and of mortgage money. The tax law grants tax subsidy to many of these suppliers and at least a portion of the subsidy will result in lower market prices of raw materials.[1]

Houses obviously are built from many types of materials and each one of them is a potential recipient of a tax subsidy. But, it is well beyond the scope of this paper to discuss all such indirect subsidies. However at least a few are so important that at least brief mention must be made. First commercial banks, savings and loans, savings banks and life insurance companies, which are major suppliers of mortgage funds, receive a variety of tax subsidies. For example, they all benefit from the capital gains provisions and the ability to invest in tax free municipals. Also savings and loans and mutual savings banks are allowed "bad debt" deductions which apparently exceed the actual deductions and thus reduce the tax base below economic income.[2] These deductions are available only if the banks have certain percentages of their assets in mortgages or real property. The bad deduction is being reduced gradually from now to 1979. Also the tax rate on interfirm dividends on stocks is only 15%. Commercial banks also can fully offset capital losses against ordinary earnings to the extent losses exceed capital gains in a year.

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[1] In a partial equilibrium setting such market prices will be lower unless the recipient industry has a vertical supply function. More complicated conditions are involved in a general equilibrium model. See Musgrave [8].

[2] See Friend [9] for a discussion of the bad debt provisions for saving and loan industry, p. 1359. He also discusses some of the commercial bank tax subsidies on p. 1388, including footnote 44. Jones [10] has an excellent summary of the tax subsidies conferred on investment of life insurance companies.

Since banks have the power to choose the date of realization of gains and losses, this provision is important. Currently large commercial banks pay a zero tax rate "because of the use of accelerated depreciation and the investment credit in their leasing companies and the application of the foreign tax credit to their foreign income." See Barr [11] p. 207, 208. Second, interest payments on life insurance are not taxable. While this may divert consumer savings from banks and other mortgage granting institutions, some funds will be diverted from the stock market.[1] Third, earnings of noninsured pension funds, who also invest in mortgages, are not taxed.

Other important raw materials receive tax subsidies. For example, timber, gravel and other major constituents of housing benefit from percentage deplection allowances which allow a taxpayer to amortize more than 100% of his investment costs.

One recent important development in the housing and mortgage field has been the government repackaging and selling of mortgages through GNMA and FNMA. Under this plan, individuals can buy and sell pooled mortgages on the bond market. But the purchase price of old issues will vary with interest rates. Thus when interest rates rise individuals can buy at a discount but receive face value when the bond matures. This difference is accorded capital gains treatment and should attract more money for mortgages and lower mortgage rates.[2] Similarly FHLBB raises money which it lends to savings and loans by selling bonds on which capital gains can be received.

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[1] Moreover life insurance companies tend to invest more in residential properties than commercial banks though less than savings and loans.

[2] In general when interest rates are considered above normal, investors can expect to receive capital gains on all bonds once interest rates return to normal.

5. CRITERIA FOR EVALUATING THE EFFECTIVENESS OF TAX SUBSIDIES

As the above inventory indicates, a substantial number of housing subsidies are contained in the income tax code. To decide whether the existing ones are useful, or should be modified or abolished, or new ones created, it is necessary to have certain criteria to evaluate the subsidies. The two most general justifications for a subsidy are income redistribution and a failure in the privately functioning market. The income redistribution argument needs little explanation at this point, though it is worth noting that until recently most economists felt that subsidies were an inefficient way to redistribute income because they restricted the recipients from spending in the way that maximized their own utility. But recently it has been observed that society approves of redistribution because the donors receive satisfaction from helping to make the donees better off.[1] If the donors' utility depends on how the recipients spend their income, subsidies may increase the welfare of society more than unrestricted cash grants.[2]

The market failure argument is a bit more complex. Economists have demonstrated that under certain conditions--including perfect competition, knowledge, and foresight, and the proper income distribution--individuals who act to maximize their own utility and profit will end up producing the amount of various goods and services that will maximize the society's welfare. But if any of the many conditions required in

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[1] See Hochman and Rogers [12].

[2] While economists accept this argument, it was made long after most subsidies were introduced into the law. But maybe the government knew this result before economists "discovered" it.

oving the above statement are violated, a private economy will not generate the social optimum. Since individuals use prices net of subsidies as signals in making their decisions, the government could give just enough subsidies so that people purchase the socially optimum amount of goods. Note, however, that while this argument implies that there is a correct amount of subsidy, seldom if ever is this optimum amount known to economists or government policy makers.

Both of these criteria have been used to justify various subsidies in housing. For example, the loan guarantee programs lower mortgage interest rates by reducing private uncertainty to (or towards) society's uncertainty level. Also there are several programs that are particularly targeted to the poor. As an alternative type of subsidy to correct market failure, it is sometimes argued that because a house is a large investment homeowners will participate more actively and wisely in local government--thus providing benefits to others in the community.[1]

While with a few exceptions, most of the tax subsidies do not go directly to those with low income, both the redistribution and market failure justifications are still made. The income redistribution argument is not so obvious but is connected with the idea of filtering.

Filtering Theory

In its grossest form, the filtering theory states that when a new luxury unit is built, the person who rents it will free up a near luxury unit which will be rented by someone else previously further down in the "quality chain." As each person moves up, the lowest quality units

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[1] Each person can sell his home, but if a community made bad decisions and many homeowners tried to sell, prices would decline.

will become vacant, obsolete and eliminated; hence, the increase in a luxury unit improves the quality available to poor and moderate income families. The theory also assumes that rents per unit of quality decrease throughout the "chain" because of the increase in supply of luxury units.

Many general housing tax subsidies are justified, therefore, on the grounds that the increase in the proportion of the national saving and investment that goes to any housing will filter down to the poor.[1] Since most current tax subsidies are not restricted to type or income level of housing, it is appropriate to ask if the filter theory is a valid description of the real world. Before attempting to answer this question, it is best to consider several different dimensions of the term "housing."

Quantity, Quality and Useful Life

At least as far back as the 1948 Housing Act, it has been a national polidy that each person or family should have "adequate housing." Adequate is an imprecise measure that, like poverty, changes with national prosperity. But the term certainly indicates that the quality of housing is important. Quality encompasses external and internal structural and neighborhood aspects.

External and internal structural aspects of quality change as a building ages. Hence, it will be necessary for us to consider both initial quality and average quality during a unit's lifetime. The latter, of course, depends on maintenance, improvement, and repair strategy adopted by the

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[1] Tax subsidies may also increase the amount of savings, but I will assume that the effect of subsidies to housing will have so little impact on total saving that they can be ignored.

landlord. The number and quality of housing units also depends on the length of time a building is used or alternatively when a building is destroyed or abandoned.

Problems with the Filtering Concept

With these definitions, it is possible to demonstrate several possible flaws in the filtering argument. First most of the tax subsidies are paid without regard to whether or not the housing unit would have been built without the subsidy. The general tax subsidies could result in more or better low income housing, but landlords of luxury buildings can respond to a tax subsidy by increasing the quality of the unit, e.g., floor space, soundproofing, equipment, etc., rather than building more units. But in this case, in the short run, there is no additional chain reaction as described above and no filtering. It seems that most new apartment buildings that are used for tax shelters are built for the luxury or upper moderate income people. Of course after 20 or 30 years, these new buildings may be lived in by the poor or lower middle class who can benefit then from the increased quality if it still exists, but there are reasons described below, for expecting that the tax laws encourage sloppy maintenance and lower quality as a building ages. Thus even in 20 or 30 years, the extra quality induced by the subsidies need not filter down and in any event 20 or 30 years is a long time to wait when more narrowly focussed subsidies can increase housing for the poor now.

There is another important aspect to the problem. In [13], Taubman-Rasche demonstrated that most subsidies will lessen the useful life of buildings even when the subsidies do not alter maintenance, repair

nd improvement strategies.[1] Since we also expect the tax subsidies to induce less maintenance, the useful lives will be reduced even more. The shorter the useful lives, the less the average number of units available and the less filtering that occurs.

Both of the above arguments suggest that luxury and moderate price buildings will have shorter lives and lesser maintenance as a result of (most) subsidies. Hence, the above statements at least cast some doubt on the validity of the filtering theory and on policies which attempt to improve low income housing by general housing subsidies.

Equity and Efficiency

Two quite general criteria in judging subsidies or tax policy are equity and efficiency. Equity or fairness involves both horizontal aspects or the equal treatment of people with the same ability to pay and vertical aspects or the proper treatment of people with different abilities to pay. A tax subsidy can be considered unfair if it is not equally available to equals or if it distorts the (socially agreed upon) progressiveness of the tax law.

An efficiently organized economy is one in which marginal social costs and benefits are equalized. Rational individuals, however, will base their decisions on private costs and benefits, which include tax

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[1] The reduction occurs because the market responds to a subsidy by reducing profits on all buildings but replacement, abandonment decisions depend on profits plus subsidies in later years only. Since most subsidies are either front loaded or constant per year, profits plus subsidies decline in later years in response to a subsidy increase.

subsidies. If private and social costs (and benefits) are the same without a subsidy, then a subsidy is inefficient with some more inefficient than others. But if private and social benefits (and costs) do not correspond, then a subsidy can increase efficiency.[1]

As noted above it is difficult to determine the exact amount of subsidies needed to achieve the most efficient allocation of resources. Thus some more modest efficiency criteria are more commonly used, of which cost effectiveness is one of the most important.

The cost effectiveness criterion can be summarized as the increase in the quantity and quality of housing per dollar of revenue loss. Cost effectiveness can vary by subsidy because some subsidies are paid to people for doing what they would have done anyway while others are paid only on marginal units.

Another related criterion is the cost of administering the tax subsidy. If the subsidy only applies to qualified investors or investments, an "inspector" has to determine if particular people or projects are qualified. Included in this criterion are the costs of illegal actions or of checking the "inspector's" actions. Also included are the costs to the taxpayer of hiring tax specialists to insure that his transaction qualifies for a subsidy.

Related to the efficiency and equity criteria are the taxpayer morale and hidden subsidy questions. If taxpayers feel that the tax system is unfair because of too many loopholes, many people, it is argued,

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[1] However, it is not necessarily true that correcting the difference between private and social benefits in one industry increases social welfare in a world in which private and social benefits differ in many industries. That is, countervailing power often is useful.

will try to cheat and evade taxes and will become cynical about the fairness of government. Some subsidy programs require Congress to appropriate funds annually. This yearly review subjects the subsidy to the continuing question of whether it is still needed and whether the proper amount is being spent. Tax subsidies do not involve expenditures and thus are continued without review and without Congressional supervision. This encourages subsidies to outlive their usefulness and to be unresponsive to fiscal crises.[1]

Relation to Other National Goals

The amount and location of housing is often related to other national goals. For example, the quality of schooling available to children depends on where they live--at least as long as current policies on busing and local financing of schools remain in effect. But some types of housing subsidies can help determine housing location and availability to the poor. Thus the subsidies can help or hinder meeting what seems to be a national goal of making quality schooling available to all.

Another set of examples concerns the controversies over open spaces, the rapidity of suburban growth, and revitalization of neighborhoods and cities. Housing tax subsidies can have important impacts on these major policy issues.

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[1] For example, in 1973 these subsidies were not subjected to impoundment though expenditure subsidies to housing were.

6. Effectiveness of Existing Tax Subsidies

In this section we will examine how well various subsidies measure up to the different criteria just given. We will begin our analysis with the rental market and will consider in most detail the package of accelerated depreciation, capital gains, limited recapture, and mortgage financing among which there are so many interconnections.

Rental Market

It is well known that this package of tax law subsidies form a primary element in the so-called real estate tax shelter. Furthermore, there is substantial evidence that the advantages of such tax shelters have been well promoted to sophisticated, high-income taxpayers.[1] This suggests that the package has been successful in increasing the share of savings going to housing. There are, however, a few caveats that bear mentioning. First, one effect of the increase in tax shelters would be to drive up prices and union wages; thus, dollars buy less housing in physical terms.[2] Second, the "professional" builders and landlords (the ones who were not attracted into the industry solely because of the tax shelters) may be investing less because their after profits have been reduced.[3] Third, with the exception of 167k rehabilitation, most of the tax shelter investments have gone into luxury or moderately expensive housing, and not low income housing. This concentration may well be due to the importance of capital gains and the highly levered investments for current (and prospective future) purchasers. Both these advantages may not materialize for lower income projects because of the greater possibility

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[1] Indeed Taubman-Rasche [4] explain most of the annual variation in multifamily housing starts by a single variable that can be thought of as the after tax profitability of investment. Also there are available various tax planning books that provide detailed analysis of real estate tax shelters and their various provisions.

[2] This assumes the long-run supply curve of housing is not horizontal.

[3] See Deffet [4] for the anguished cries of one professional.

of neighborhoods deteriorating. Of course the increase in expensive apartments can still benefit all renters if, contrary to objections raised above, the filter theory is correct. Finally, it must be emphasized that we really do not know if housing is more or less subsidized than other investments. I don't think anyone knows all the direct subsidies paid to all assets, and the interindustry price effects or indirect subsidies are terra incognito. Thus it is possible that the tax and other subsidies conferred on housing may not fully offset the subsidies conferred on other investments, in which case housing would still be underfinanced, or vice versa.

The accelerated depreciation, capital gains, leverage package has probably increased the number of units built and the initial luxuriousness of these buildings. But average quantity and quality may have decreased because of effects on maintenance and repair and on useful life. That is, these subsidies will cause owners to reduce maintenance and repairs. First, both the capital gains provision and the decline in the annual interest deductions as mortgages are repaid favor rapid turnover in ownership.[1] Many people feel that rapid turnover leads to shoddy maintenance because the current owner gets out before the effects of shoddy maintenance comes to haunt him. (See Deffet [4].) While I don't know of any empirical work that bears directly on this question, economic theory suggests that this ought to happen. To see this, suppose that any outside investor finds it difficult to establish the exact quality of a building or how many corners have been cut in maintaining the building. Then owners who have a building which on the surface appears to be in good shape--though in fact undermaintained--will receive extra profits. Of course, investors will eventually learn that the average quality of buildings is less

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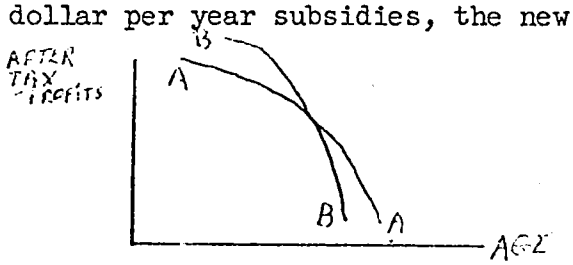
[1] It is important to remember that even after the 1969 changes the recapture rule only applies to depreciation in excess of straight line, but straight line depreciation apparently is a subsidy. Also, recaptured excess depreciation still allows taxes to be deferred for substantial periods. When the large in-

than what they anticipated, but as long as they can't easily distinguish the good from the bad, they will pay an average price for both types.[1] In this type of a market it will still pay for all owners of buildings to undermaintain and receive the average price when they sell. Even if eventually all owners are driven to maintain at the same level, the average maintenance and quality will be less under a system that encourages rapid turnover than when the consequences of shoddy maintenance are internalized through a system that encourages long-term ownership.

It probably is even more difficult for tenants to determine quality. Hence, the same argument would suggest that even for new buildings short-term ownership would encourage high surface quality, but reduced quality for hard-to-observe items. While I think this conclusion is true and there are confirming newspaper stories, about the only "hard" piece of evidence I know of, is oral complaints from landlords that a 40-year life is too long since they don't build apartment buildings the way they used to.

Repairs and maintenance may also be reduced for one other reason. Let the equilibrium age profile of after tax profits be represented by the line AA in figure 1. Now let a tax subsidy be introduced. For front loaded or constant dollar per year subsidies, the new profile of after tax profits



After Tax Profit Profiles as a Building Ages

Figure 1

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[1] If it were inexpensive to determine quality, this need not happen.

(including subsidy) will look like BB once the market has adjusted to the increase in supply induced by the subsidy.[1]

Since on this new profile net profits in later years are smaller it would be less profitable to maintain and repair buildings.[2]

Buildings will be destroyed when annual profits are less than the return that can be made by selling the land and investing the proceeds.[3] Thus when BB is substituted for AA, destruction occurs earlier. If maintenance is lessened for either reason given above, BB will shift further to the left and useful lives will be shortened still more and average lifetime quality will decline.

To summarize this material, it seems likely that the tax subsidy being discussed has increased the quantity of buildings and especially expensive buildings. It may also have increased the surface luxuriousness buildings. But partly because of market adjustments to subsidies and partly because of the incentives to rapid turnover and thus to shoddiness, the useful life and true quality are probably reduced.

This particular set of tax subsidies does not seem to involve much additional recordkeeping and administrative costs for the taxpayer or the IRS. But as with most tax shelters, individuals will spend resources on tax lawyers and accountants to insure that they benefit from the law. In addition, there are now tax shelter brokers who are paid to find the right shelter for the right group of (passive) investors.

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[1] See Taubman - Rasche [13] for a proof.

[2] For certain shapes of AA or subsidy packages which are concentrated at the end of the assets life, opposite conclusions follows.

[3] The owner need not sell the land but can rebuild himself. In slums, the ilding will be abandoned when profits are negative.

The many tax shelters together have helped to reduce both the progressiveness of the income tax (vertical equity) and invalidate the principle of equal treatment of equals (horizontal equity).[1] If only the housing tax shelters were eliminated, the situation would probably change little. But the existence of a tax subsidy to one industry is often used to justify a subsidy to another "to reestablish equity." Thus it seems fair to say that the housing tax subsidies help contribute to the erosion of vertical and horizontal equity.

In a more general sense, the inequity arises because of the progressive tax rate schedule. As people invest in tax shelters, the before tax return will adjust so that the after tax rate of return on all assets--sheltered or not--are the same for the "marginal" investor. If this marginal investor were in the top tax bracket, the tax shelter would erode the tax base but the top bracket person would lose in his before tax "dividends" what he gains in tax savings; i.e., he would have the same after tax return as another top tax bracket investor in a nonsheltered asset. But because there are so many tax shelters with such large subsidies, the tax bracket of the marginal investor in rental housing is probably less than 50%.[2] Since the market established an equilibrium for a tax free asset A and another B in which $r_A = r_B(1-t)$, those in the tax brackets higher than that of the marginal investor receive substantial benefits

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[1] See Pechman and Okner [16].

[2] Tax free municipal bonds have generally yielded about 60% to 65% of comparable quality corporate bonds. Assuming no difference in transaction costs, the after tax yield of the two assets should be equal for the marginal investor or municipal = corporate (1-t). Hence, the marginal tax bracket (t) for this tax shelter must be 35% to 40%.

from the tax sheltered asset A. That is their after tax return is the same as if they invested in B and paid the rate, t, of the marginal investor.

Next let us consider the cost effectiveness of these subsidies. As they are structured these subsidies are available to all investors in new and used housing. If there were no subsidies, nearly as much housing would be built and maintained. That is, since available evidence as summarized in de Leeuw [16] would suggest a housing price elasticity between 0 and -2, a 10% subsidy would increase the quantity of housing no more than 20%.[1]

Because the subsidies are paid on all housing including those that would have been built anyway and because the supply response to price changes is limited, these subsidies are very expensive. A hypothetical example will best illustrate this. Suppose that without the subsidies there would be 1000 houses costing $100 each. Next, suppose that tax subsidies of 5% are introduced and that this increases the supply of housing 10% to 1100 units. For simplicity assume that the construction cost remains at $100. The total cost of the subsidy is $5500 ($5 times 1100 units). Thus, the average effective subsidy cost for each of the 100 new houses produced by the subsidy is $55 or 55% of the construction cost of houses.[2] Thus, this tax subsidy which is paid on all housing

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[1] It is worth noting that houses were built in large number before these tax subsidies were given and continued to be built at a rapid rate after the tax subsidies were reduced in 1969.

[2] If instead the price elasticity of demand were -4, a 5% subsidy would cause 200 extra units to be built for an effective subsidy cost of $30 or 30% per new unit.

will rate low on the cost effectiveness criteria (unless the price elasticity of demand is huge).

There are a number of different ways in which the housing market fails. These are discussed in detail in [4] and include imperfect competition in building trade unions and among construction firms, lack of complete knowledge about prices and quality, the difference between the amount of private and social riskiness in investments, and costs and benefits that accrue to the owner or renter of a particular house, i.e., externalities. The riskiness problem has been attacked directly through loan guarantees. The remaining causes of market failure would justify some subsidy though it is not clear how much.[1] In addition this particular set of subsidies probably worsens rather than improves the situation with regard to knowledge of quality.

The final criteria we will consider is the impact on other goals such as educational equality and redevelopment or stabilization of the cities.[2] In principle, the accelerated depreciation subsidies should be neutral with respect to these goals since all rental housing in any location is eligible. In practice the importance of the capital gains provisions and of leverage seems to restrict the subsidy to at least moderately expensive housing. Thus inner city slum or deteriorating neighborhoods won't be fixed up.

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[1] Moreover it is suggested in [4] that the markets for all other investments are affected more severely by these same problems and that housing may be receiving too large subsidies relative to other assets.

[2] The impacts on any national goal could be studied. These seem likely to be effected.

Of course if the filter theory were correct, the subsidies might help disburse he poor through the city and equalize educational opportunity within a city, but subsidies have been paid for years and disbursement is far from a fact. More importantly, the flight of renters to the suburbs where it is easy to put up large complexes will hinder educational opportunity as long as political and tax boundaries are maintained. Similarly, the tax subsidies would seem to encourage urban sprawl and the using up of open space.

Section 167k

The 5 year writeoff provision of section 167k for rehabilitation expenditures is different from the other subsidies in that it is restricted to low income units and that it is not paid early in the assets life. I have yet to see a study on how successful this tax subsidy has been in attracting investors though I think it should be successful. Since investors an write off the costs of rehabilitation over 5 years, regardless of the useful life of the building, the subsidy will be more valuable for those types of rehabilitation that generate profits over long periods. Thus this subsidy should increase quality and useful life. However, since the same limited recapture rules described previously apply, there will be a tendency for quick turnover in ownership and thus an emphasis on surface rehabilitation.

Once again, the wealthy investors benefit more from this subsidy than the nonwealthy and there is erosion of the principle of equal treatment of equals. However, in terms of renters, the benefits of improved housing or lower rents for given quality go to low income people quickly. There are, however, certain administrative costs necessary to make sure that only low income units are rehabilitated.

This subsidy will have effects concentrated in low income, deteriorating and slum neighborhoods. Thus, this subsidy should have beneficial consequences towards such goals as reviving the cities, checking urban sprawl and saving open spaces. It is not clear what the effect, if any, would be on educational opportunity.

Since little in the way of rehabilitation occurred without the subsidy, section 167k is not paying people to do what they would have done anyway. That is, it shows up well on cost effectiveness. Thus the program can be justified on equity grounds (though a tax credit for rehabilitation may be better). There also may be an efficiency argument since there are special risks in long term investment in such areas as well as externalities or neighborhood effects.

her Tax Subsidies to Rental Housing

The other tax subsidies to rental housing are not as important and will be covered more briefly. First, the further deferment of capital gains tax beyond realization or complete forgiveness has the same type of impacts as capital gains taxes.[1] The tax subsidies on equipment should be successful in inducing landlords to put in more and better equipment. Whether equipment is substituted for shell quality will depend on their relative subsidies.[2] It is worth noting that with a fixed pool of national saving, resources spent on equipment are diverted from all other forms of investment.

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[1] Except the death provision will cause people expecting to die to hold on to an asset.

[2] However, equipment may be substituted for future labor and other operating costs, e.g., equipment that breaks down less frequently may be used.

Thus, more equipment per building may result in a reduction of the number of buildings. The equipment tax subsidy also is paid to people who would have purchased the items without the subsidy. This subsidy, however, probably does better than the accelerated depreciation on the cost effectiveness criterion since builders can more easily substitute items--such as refrigerators, air conditioners, etc.--that the renter could provide for himself but without receiving this subsidy.

The administration cost of ADR and the investment tax credit on housing equipment are not particularly large especially since complicated tax problems are not involved. Tax credits--as opposed to deductions--have a value to the taxpayer that is independent of his tax bracket. Thus, ADR tends to benefit the wealthy tax shelter user more than the investment tax credit. The tax credit is not available on used equipment; hence, low income housing may benefit less. Since the other tax subsidies tend to favor luxury buildings which have to be equipped, and since such buildings have more equipment (including appliances) the equipment subsidies are shared by renters and owners of such buildings.

The previous arguments on life of buildings and short term ownership still hold. But the subsidy may induce owners to use equipment which will require less repairs. Hence the average quality of part of the housing services may be increased. There is no obvious effect of this subsidy on other national goals.

The ability to expense some costs whose associated revenues are taxed as capital gains should encourage people to make these expenditures. The types of items generally included in this category are painting, decorating, and repairs to visible items. Thus this subsidy will tend to increase some parts of lifetime quality. In other respects this subsidy's effectiveness is like accelerated depreciation except that there is no obvious connection with other national goals.

The various subsidies to renters where the subsidy value is not included in taxable income should help the beneficiaries obtain more and better housing. By increasing the demand for quality, there is every reasons to believe that the price of quality will rise and that buildings will be better maintained. With the possible exception of FHA and other mortgage guarantees, most of these subsidies do not reach all who are eligible or most of the poor; hence, these subsidies are horizontally inequitable. Indeed since mortgage lenders tend to "redline" out certain areas as too risky to invest in and to exclude poor people who are poor credit risks, many of the credit guarantees won't benefit the poor directly. The proposal may help filter the poor throughout a city and suburbs thereby helping on educational opportunity, but hindering attainment of open space goals. However, this tentative conclusion should be re-examined on a program-by-program basis; task that is beyond the scope of this paper.

Owner Occupied Housing:

The tax exemption of income but deductibility of interest and property taxes of owner-occupied housing provide important incentives, which are partly offset by property taxes, for people to own their own homes.[1] It is difficult to determine, however, whether tax subsidies or lower mortgage costs arising from FHA programs and subsidies to mortgage companies have influenced people to become homeowners.

With our progressive income tax rate schedule, this tax subsidy conferred more of a benefit on the wealthy (when enacted). We would expect this subsidy to lead to increased home prices and if the differentials can

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[1] The subsidies to luxury buildings work in the opposite direction.

be attuned to income level, the wealthy person who buys currently need not obtain a bigger subsidy. But I know of no study which indicates the effect of such subsidies on differently priced houses.

The subsidy not only encourages people to buy a house but also to buy better houses. For the same reasons given before these subsidies will reduce the useful life of a house for a given repair strategy. Repairs costs are not treated in a neutral manner by these tax provisions. The cost of repairs is not deductible from taxable income, but the revenues are not taxed as ordinary income. The repairs should increase the selling price of the house which is subject to a (deferable) capital gains tax, but the costs of any improvements in the house are fully deductible even if the improvements have depreciated since being made. All these provisions suggest that repairs are subsidized and housing quality will be maintained.[1] Moreover, the owner who expects to be living in the house for a long time has an incentive to institute the optimum repair plan.

These tax subsidies also pay a person for doing what he would have done anyway. Since the price elasticity of demand almost certainly does not fall outside of the 0 to -4 range discussed earlier, this subsidy is very costly.

These are some costs of administering this tax since the taxpayer must keep records of property tax and interest payments. Moreover, nearly all homeowners itemize, thus they must also keep records on their other deductions.

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[1] However, the shift in the age price line as in figure 1 and the shortened life of houses will cause people to repair less.

These homeowner subsidies may make the attainment of the educational quality goal more difficult especially since home ownership is more valuable to those with more income. In addition these subsidies may lead to tract or neighborhood development of owned housing, i.e., spatially segmented markets. If these markets correspond to political entities, which are endowed with different tax base per student and different quality schools, equality of educational opportunity is weakened further. Moreover since single family homes require more land per square foot of housing, there is a connection with urban sprawl, decay of the cities, etc.

About the only new complication introduced by capital gains taxes is that people should be less willing to move as their income, family size, or other determinants of housing size and location alter. The various deferral schemes remove this effect, and some of the "social stability" used justify homeowner's subsidies.

Indirect Tax Subsidies

Tax subsidies given to suppliers of housing raw materials lower the cost of building and operating owned and rented housing. As long as owners base their decisions on the after tax rate of return on investments or renters on the net rent they must pay, indirect subsidies that reduce costs are as effective in increasing housing as subsidies that raise revenues by the same amount. However, a problem with using indirect subsidies to stimulate housing, is that all users of the raw materials (including mortgages) also benefit from the subsidy and absorb part of the stimulation.

Indirect subsidies will benefit all types of housing though some types of building materials or sources of mortgage are more heavily used by multi- than single-family homes and vice versa. An unusual consequence of these subsidies is that the effects are more valuable for the less well off. For example, the lower interest rate on mortgages will mean smaller itemized deductions (for a given mortgage) on the 1040 form. A reduction of $1 reduces taxes by t dollars where t is the persons' marginal tax rate. The larger the tax rate, the bigger the reduction in taxes for a given deduction. But each dollar decrease in deductions will increase taxes more for those with larger t's. This example should not be construed to mean that those with higher incomes don't benefit from a reduction in interest rates since they and all investors will find their after tax profits increased when interest costs decline unless the marginal tax rate is 100%.

The tax subsidies to mortgagors may not directly increase housing for the poor since the mortgagors often won't extend credit to poor risk areas or poor risk persons at any feasible rate of interest. (Their extra supply of investible funds will either go into nonmortgages, reduction in down payments, or be reduced by lowering the interest rates they pay to attract deposits.) Without going into much more detail than is possible in this paper, it is difficult to evaluate individual subsidies on the other criteria.

Manipulation and Expansion of Existing Subsidies

To my mind most of the existing tax subsidies show up so poorly in the above evaluation that they should not be enlarged. (The one

possible exception is section 167k, which may prove successful, but which could probably be improved by substituting a tax credit for accelerated depreciation.) Instead serious consideration should be given to substituting either housing grants or other tax subsidies such as those described below. Earlier I argued that straight line depreciation is too rapid. Thus I would favor eliminating accelerated methods, but Taubman-Rasche [4] suggest that disallowing capital gains treatment for apartment buildings may be more important presuming that it is impossible to institute a depreciation system slower than straight line.

7. New and Improved Tax Subsidies to Housing

The above evaluation would indicate that most of the tax subsidies to housing are expensive given the extra housing they produce, that they provide a tax shelter for upper-income persons, and that they tend to discriminiate against proper maintenance and repair practices and lead to an artifical shortening of the useful life of a building. In addition, while in principle, most of the subsidies apply to all housing, in practice moderately or very expensive housing has been produced by the tax subsidies. For several reasons, these changes may not filter down to the poor as increased quality or lower rents.

Criticisms such as these have led many commentators to conclude that other types of government intervention would be better than the existing tax subsidies. Some of the criticisms may apply to all tax subsidies, but in this section I will try to propose and evaluate some additional tax subsidies to housing. But before doing that, I must mention that the single most important development in the tax subsidy field that would spur housing would be to eliminate all other tax shelters. If housing tax shelters were the only game in town, sophisticated investors would quickly pour money into them.

Tax Credits on New Houses

Perhaps the most obvious new subsidy would be a tax credit on rental building. Such a credit has a number of advantages as compared to accelerated depreciation for which it is often considered to be a substitute. Since the credit need not artifically change the tax basis, the credit does not create capital gains, and thus avoids encouraging rapid turnover and the associated maintenance problems. And as shown in Taubman-

Rasche[13], the tax credit will reduce useful lives less than accelerated depreciation with a subsidy of the same (present discounted) value. If the tax credit were claimable only against housing income, the credit could not be used by investors whose profit comes from tax losses arising from any remaining tax subsidies such as excess depreciation, etc. The credit, moreover, would benefit taxpayers in all tax brackets equally. Thus, this subsidy would be of more value to the builders and owners who maintain and operate their own buildings than to the amateurs who are passive partners in tax shelters. The credit could also be designed to encourage long-term ownership and thus better maintenance by spreading the credit over a 15 or 20 year period, with eligibility contingent on continued ownership.[1] If the credit can only be claimed against profits from housing, people would have an additional reason to maintain the building.

Even this credit would still pay people to do mostly what they would have done anyway. Thus, the credit would be expensive. It can be made more cost effective by restricting its use to housing erected in slum and other areas where little private building occurs or by tying the subsidy to the percentage of people receiving rent supplements, etc. Also the credit could be given only to major improvements (for all or low income housing, and be a substitute for section 167(k). This would increase quality and probably aid in filtering decent housing to the poor and maintaining neighborhoods. This, of course, would involve higher costs of administration and evaluation.

Given our earlier discussion on equipment, it is natural to examine the equivalent of ADR, that is, a shortening of tax lives. This is a much inferior subsidy since it would accentuate the capital gains and

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[1] Corporations could get around this requirement by becoming a wholly owned subsidiary of another company. But corporations are not that important in this industry.

short-term owenership repair problems and would continue to concentrate its benefits on tax shelter investors rather than all taxpayers. Of course, the short tax lives might be extended only to certain types of housing, city areas, or improvements, but there is no reason why the same could not be done with a tax credit.

Mortgage Lenders

It is possible to design tax subsidies that keep the "amateurs" out of the operation of rental housing, strengthen long-term ownership, and yet attract funds into housing from a wider spectrum of the public. For example, if the tax subsidies were given to the lenders of housing capital rather than the owners, there would be lower mortgage rates yet the incentives to rapid turnover of buildings could be avoided or muted since no capital gains are created as the building ages.[1] Moreover as argued earlier, the reduction in interest payments are more advantageous the lower the persons tax bracket; hence, there would be less of a competitive advantage for people in the top tax bracket. The tax subsidies could be structured to exempt all or part of the profits of housing mortgages from federal income tax. (By encouraging an increase supply of housing mortgage funds, interest rates would be lowered.) Since there would be problems in determining the profits on housing mortgages in financial intermediaries such as life insurance companies that invest in many types of assets, an alternative approach of housing mortgage tax credits might be preferable.

There is no economic reason to restrict this type of operation to the existing direct lenders. Instead FNMA and GNMA obligations could be

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[1] There is less need to worry about rapid turnover of loan instruments.

made eligible for partial or total tax exemption or for tax credits. Since the credit reduces taxes equally for people in all brackets, the credit would be more attractive to people, in say, the 25% to 40% tax bracket range. FNMA and GNMA could purchase all housing mortgages or home repair loans offered to them.[1] Alternatively, these agencies could restrict the use of such tax subsidized funds to low income housing, rehabilitation loans, etc. To determine how much funds were tax subsidized, the agencies could have separate issues of taxable and tax exempt (or eligible for credit) instruments.

The reduction in mortgage rates can be quite an effective tool. For example, Taubman-Rasche indicate that a change in the mortgage rate of 100 basis points is as powerful as a change for rented housing as a change from double declining balance (150 on used buildings) to straight line depreciation. Among homeowners the mortgage reduction will be more important for people in lower tax brackets and will be more conducive to long-term ownership. The long-term ownership could be made even more attractive if mortgage repayments were changed so that the interest portion either remained constant or increased as the mortgage aged. These types of mortgages could be made a condition for tax subsidy.[2]

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[1] If it is desired that banks exercise discretion and not make and then sell to GNMA very risky mortgages that the banks would not normally have granted, GNMA need only buy 75% of each mortgage. However, given "redlining" practices of banks, it may be socially desirable to encourage lenders to invest in risky areas to improve housing for the poor.

[2] Series E bonds are a precedent for such a pattern. Since the debtor would be paying too little interest in the early years on the existing principle, there would have to be a provision that if the mortgage were repaid early a lump sum payment which would be equal to the difference that would have been paid on a conventional mortgage.

ax Subsidies to Excess Rent

Another form of tax subsidy would allow either a deduction or tax credit for "excess rent." Under this plan excess rent would be, say, any amount more than 30% of adjusted gross income. A credit seems a better procedure for several reasons. First,many renters do not itemize and may not find it to their advantage to do so even with this new deduction. A credit, however, would be available to all renters. Secondly, as noted before, credits reduce tax payments equally in all tax brackets while deductions are worth more the higher the tax bracket.

The credit plan could be adjusted so that the size of the credit was a function of income. For example the total credit could be adjusted (multiplied) by a fraction whose level decreased continuously from 100 o 0 per cent as income rose. Alternatively, there could be an income level above which the credit didn't apply though such features imply very high marginal rates for some level above the cutoff point or notch.

There is in existence a subsidy plan under which eligible persons pay 25% of their income for rent with the government paying the remainder of the market determined rent. An objection that has been made to this plan is that the eligible renter has no incentive to economize on his rent payment (or search for another apartment) since once he spends 25% of his income, the rental price to him on any excess expenditures falls to zero. If the credit were 100% of the excess, the same objection would hold (though it is important to note the same complaint would not hold for a tax deduction). As a response to this objection, the credit could be made only 50% of the total excess rent. A major advantage of this plan, s opposed to the existing rent supplement plan, is that many more people

would benefit and there would be no horizontal inequity. This plan would also reduce the cost effectiveness problem since the 30% of income restriction will eliminate much normal spending on housing from being eligible for the subsidy. Also, if saving rates increase with income, especially above, say, $20,000, the poor and middle class would be more likely to meet the criterion.

The tax credit plan may involve some administrative costs. For example, should rent include utilities, or be adjusted for furnishings supplied. In addition, what would happen if neighbors began to rent houses to one another at inflated rates? Also, a decision would have to be made about the treatment of those who owed no tax before subtracting the credit. Moreover, to avoid millionaires who invest in tax free assets from benefitting excessively from this provision, a stringent definition of income would be necessary.

Tax Subsidies to Increase Useful Life and Repair and Rehabilitation

Most of the existing and newly proposed subsidies tend to decrease useful life and decrease incentives for repair because the profits at all ages are reduced (because of increased supply) while the subsidies are largest early in the assets life. More decent housing would filter down to or be rehabilitated up to the poor, if such negative incentives were lessened or positive subsidies were granted to repairs. As previous discussion has indicated, the negative subsidies can be lessened by spreading the subsidy throughout the asset's life or better still by having subsidies increase with the age of the building. This is one reason why it was suggested that subsidized mortgages be designed to have interest payments larger at the end of the asset's life. Another mechanism would

a tax credit, based on original cost, which is applicable only against the tax arising from profits made from each building, that is, paid at an increasing rate as a house ages with no credit paid until the structure is 30 years old. Since this subsidy would only be applicable to buildings showing a taxable profit, it would encourage repairs. A variant of this would be to base the tax credit on the repair costs while having the credit paid annually and at an increasing rate.[1] It would also be possible to reduce continuously the tax rate on earnings on buildings beyond a certain age. This certainly would encourage repairs especially if it were possible to write off the repairs during the earlier periods of higher tax rates; however, there may be high surveillance and record keeping costs since taxpayers would want to write off all expenses during high tax rate periods. Finally tax credits could be given to building companies on each housing until sold. While encouraging more construction, this method would be neutral towards type of ownership. Since, it would be partly passed along as a lower price and tax basis, capital gains problems could be created.

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[1] A disadvantage of this variant is determining what are eligible repair costs.

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4024

Appendix B

Effects of Treasury Tax Proposal on Multifamily Housing Investments

ABSTRACT: This paper seeks to assess the effects of the recent Treasury Department tax proposals on multifamily housing investments

Discussion Draft No. 2 Date 6/22/73

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Office of Economic
Analysis

May 29, 1973

Effects of Treasury Tax Proposal on Multi Family Housing Investments

Introduction

This paper seeks to assess the effects of the recent Treasury Department tax proposals on multifamily housing investments. It does so by examining the financial attributes of four apartment houses, identical in all respects except the means of financing and the "other income" of the owners. It is assumed that two of the housing projects are financed under the Section 236 program by limited dividend sponsors, with one group of investors having "net related income" from other apartment houses sufficient to permit them to benefit fully from the tax losses generated by the Section 236 project. For the second Section 236 project it is assumed that the investors do not have any "net related income" against which they could apply tax losses from the project.

It is assumed that the other two identical apartment houses are financed by conventional loans, with one group of investors having "net related income" from other apartment house investments sufficient to make full use of their tax losses. For the other apartment house it is assumed that the investors do not have any "net related income." For all four projects it is further assumed that the owner is a partnership consisting of individual investors, each of whom is in the 50 percent tax bracket with "tax

preferences" of less than $30,000, i.e., they are not subject to the existing 10 percent minimum tax.

The paper is divided into three sections. The first section describes the Treasury Department tax proposals that bear upon multifamily housing investments. The second section details the financial characteristics of the four projects and the third section measures the impact on cash flows, tax benefits and tenant rentals resulting from the proposed tax changes.

A. Proposed Tax Changes

The Treasury Department tax proposals that were sent to the Congress on April 30, 1973 contained two sections that bear upon multifamily housing investments. First, in lieu of the minimum tax on "tax preferences" that was authorized by the 1969 Tax Reform Act, the Treasury proposes a new concept termed "Minimum Taxable Income." Under the 1969 law the taxpayer grouped certain "tax preferences" such as excess depreciation (accelerated depreciation less straight-line depreciation) on real property, the capital gains deduction (generally one half of the capital gain), percentage depletion, accelerated depreciation on personal property and stock options which were taxed, after deducting $30,000, at a flat 10 percent tax.

As a substitute, the Treasury proposes that each taxpayer should compute an "Expanded Adjusted Gross Income" (EAGI) which is defined as his adjusted gross income under present law plus percentage depletion, the excluded one half of net long-term capital gains, exempt income from foreign

sources, and the nontaxable bargain element in certain stock options. From this EAGI he subtracts his personal exemptions, a $10,000 floor in lieu of various deductions, extraordinary medical expenses and casualty losses and investment interest (and investment expense) to arrive at his minimum taxable income base. One half of this MTI base constitutes his "minimum taxable income" which is taxable at the appropriate tax rates in the Code ranging from 14 to 70 percent. Every individual taxpayer would be required to pay tax on the greater of a) his minimum taxable income or b) his normal taxable income computed in the usual manner.

The second major change proposed by the Treasury that affects multi-family housing investments is a limitation on artificial accounting losses (LAL). This is designed to eliminate tax shelters by no longer permitting the creation of artificial tax losses from one enterprise to be deducted against (and provide a shelter from tax on) other unrelated income. Under existing law a taxpayer can deduct tax losses resulting from accelerated depreciation that arises from an investment in a multi-family residential project from his other income. These "tax shelter" deductions reduce his taxable income and his tax liability is decreased accordingly.

The proposed limitations on artificial accounting losses do not disallow the artificial accounting losses arising from accelerated depreciation. Instead, the limitation would require that they can only be deducted against

a net income against which he can apply the construction period losses. Or, he can apply these losses against the net income from his other apartment house projects.

B. Financial Characteristics

1. Basic Assumptions. For the purpose of this analysis, it is assumed that there are four identical apartment house projects, each with 125 dwelling units. It is further assumed that for each building the land cost is $220,000, that the cost of construction eligible for depreciation is $1,600,000 and that the construction costs possibly deductible during the period of construction (interest and taxes) amount to $80,000. For each project it is assumed that the "builders' and sponsors' profit and risk" arising from the construction and development of the apartment house is $100,000. It is further assumed that each project sponsor is organized as limited partnership consisting of private investors, each of whom is in the 50 percent tax bracket with "tax preferences" of less than $30,000, i.e., they are not subject to the ten percent minimum tax.

Thus, the total development cost (the sum of the foregoing cost elements) comes to $2 million. For the Section 236 projects this $2 million apartment house is financed by a 90 percent loan, repayable over 40 years at 7 percent interest (with no discount points). The difference between the $2 million total development cost and $1.8 million mortgage loan constitutes the investor's equity, of which half represents a cash contribution of

$100,000 and the other half represents the "builders' and sponsors' profit and risk" allowable under HUD regulations.

In the case of the conventionally financed projects, the means of financing are somewhat different. Since the maximum loan obtainable is generally 75 percent of the appraised value, the owner usually expects to minimize his cash contribution by obtaining an appraisal of the completed project in an amount that exceeds the foregoing $2 million total development cost. Ordinarily, a lender is willing to go along with this higher appraisal value (calculated by capitalizing expected net rental income), especially if it expects that the projected net income of the project will, indeed, be realized so that the value of the project will necessarily appreciate. Accordingly, it is assumed that the conventionally financed projects are financed by loans for $1.6 million, 75 percent of an appraised value of $2,133,000, repayable over 25 years at an interest rate of 9 percent (with no discount points).

For the conventionally financed projects, it is further assumed that the owners initially provide a cash investment of $300,000, or 15 percent of the project's development cost. (The Touche Ross and Company study on "Tax Considerations Affecting Multifamily Housing Investments" reports that typically the owner's cash contribution accounts for 15 percent of the total project's cost.) However, their total equity comes to $533,000 (25 percent of the appraised value of $2,133,000). The difference between their

$300,000 cash contribution and their total equity represents their non-cash equity, of which $100,000 is the "builders' and sponsors' profit and risk," and $133,000 reflects the difference between the appraised value and the total development cost. These financial characteristics are summarized in Table 1.

2. Rent and Revenue Schedules. To facilitate review of this analysis, Table 2 shows the cost components that give rise to the ultimate monthly rentals charged on a per dwelling unit basis. For purposes of comparability, it is assumed that the maintenance and operating costs per dwelling unit are $44 per month for each project, that contributions to a replacement reserve are $6.40 per month and that the property taxes are $13 per month for each project. A replacement reserve is required by HUD and is assumed to be required by the private lender. Contributions to the reserve are not tax deductible until the moneys are spent. For the Section 236 projects, the cash return on total equity is calculated at $8 per month (the allowable 6 percent return on total equity under HUD regulations), whereas the cash return for the conventional projects is calculated at $28 per month (the net cash return of 14 percent of cash equity found by the Touche Ross study).

Allowing for an assumed occupancy rate of 95 percent and monthly debt service of $94.80, the gross monthly rental required for the Section 236 projects is $180.21. At a 25 percent rent-to-income ratio, the income levels served would be approximately $8,652 per year. However, the interest

reduction subsidy can reduce the monthly debt service to as low as $36.40, which would decrease the basic gross rental to $118.74. At a 25 percent rent-to-income ratio, the maximum interest reduction subsidy makes it possible for the Section 236 projects to serve families with incomes of up to $5,700 per year.

By way of contrast, the monthly debt service on the conventional loans comes to $107.40 per month per dwelling unit. At a 95 percent occupancy rate, the gross rent comes to $214.53 per month. At a 25 percent rent-to-income ratio, the conventionally financed projects would serve families with annual incomes of $10,296.

C. Effects of Proposed Tax Changes

1. Cash Flows and Tax Benefits. Tables 3 and 4 show the cash flows and tax benefits for the Section 236 and conventionally financed projects respectively, under existing tax provisions. The tables cover the construction period (assumed to be one year) and 10 years of project operations. To simplify the presentation, it is assumed that the tenant rental receipts, the maintenance and operating expenses, and the real estate taxes remain constant throughout the 10-year period. It is further assumed that the accelerated depreciation allowances are calculated on the basis of the 200 percent declining balance method over a 40-year useful life (in accordance with the IRS guidelines for useful life).

As will be noted from Table 3, in the case of the Section 236 project, the total deductible expenses exceed total revenues in each of the 10 operating years so that the owner has a tax loss which can be applied to his other taxable income. In contrast, in the case of the conventionally financed project (Table 4), a taxable loss occurs only in the construction period and in the first two years of operation. Thereafter, the rental receipts (which are assumed to be constant in each year) exceed total deductible expenses by increasing amounts, which give rise to taxable income. In other words, the Section 236 project provides a larger amount of tax shelter over a longer period of time than does a comparable conventionally financed project.

The greater tax shelter for the Section 236 project is due largely to the manner of financing in that interest payments for the 25-year, nine percent loan decline more rapidly than do the interest payments for the 40-year, seven percent loan. Moreover, since there is a smaller cash return for the Section 236 project, the tax shelter has less project income to protect and, consequently, more of the tax shelter is available as a tax loss to be applied against other taxable income of the investor.

The balance of Tables 3 and 4 shows the annual rates of return resulting from cash flows plus tax benefits, as compared to the owners' cash equity and also as compared to the owners' total equity. As will be noted, the rate of return on cash equity ranges from 37 1/2 percent in the first year

of operation to 19 percent in the 10th year of operation for the Section 236 project. For the conventionally financed project, the rate of return on cash equity ranges from 15.8 percent in the first year of operation to 7.1 percent in the 10th year of operation.

The rate of return on the owners' total equity (cash plus non-cash equity) ranges from 18.7 percent in the first year of operation to 9.5 percent in the 10th year of operation for the Section 236 project. For the conventionally financed project, the rate of return on total equity ranges from 8.9 percent in the first year to 4.0 percent in the 10th year.

Under the Treasury tax proposals the foregoing would prevail if the investors in the project have "net related income" from other apartment house investments sufficiently large to absorb all of the tax shelter generated. If the investors in the respective projects do not have "net related income" from other apartment house investments, they would defer utilization of the tax shelter generated until they had such income. In the meantime they would have to pay higher taxes. The extent of the higher taxes is shown in Tables 5 and 6.

Table 5 depicts the changed tax benefits for investors in the Section 236 project. In the construction year their tax shelter would drop from $80,000 under the present tax law to zero under the Treasury tax proposal (but the $80,000 would go into the Deferred Loss Account). In the first

year of operation their tax shelter would decline from $50,930 to $10,930 (i.e., the $40,000 artificial tax loss would go into the Deferred Loss Account). In the tenth year of operation their tax shelter would decrease from $13,900 to $3,500 (i.i., the $10,400 artificial loss would go into the Deferred Loss Account).

Because of these reduced tax benefits, the rates of return to investors in the Section 236 project drop sharply. For the construction period the return declines to zero from 40 percent on cash equity and 20 percent on total equity. In the first year of operation the rate of return decreases from 37.5 percent to 17.5 percent on cash equity and from 18.7 percent to 8.7 percent on total equity. In the tenth year the rate of return decreases from 19.0 percent to 13.8 percent on cash equity and from 9.5 percent to 6.9 percent on total equity.

In the case of the conventionally financed project a much different picture emerges as a result of the Treasury tax proposals. In the construction period the tax shelter drops from $80,000 to zero (but the $80,000 goes into the Deferred Loss Account). During the first year of operation the tax shelter of $10,580 becomes instead an addition to the Deferred Loss Account. During the third through part of the ninth year the artificial losses from the construction period and the first two years of operation, which had been accumulated in the Deferred Loss Account, are applied against the project's taxable income. As a result, instead of paying tax on the

project income during these years (see Table 4), the investors have a zero tax liability on account of the project. (see Table 6) After exhausting their accumulated artificial losses, the investors have to pay tax on project income, net of the excess depreciation in years nine and ten.

In terms of rates of return, investors would actually find higher returns during the third through ninth years of operation under the Treasury tax proposal as compared to the present tax provisions and in year ten of operations there would be no difference. In year three the return would rise from 13.9 percent to 14.0 percent on cash equity and from 7.8 percent to 7.9 percent on total equity. In year eight the return rises from 9.1 percent to 14.0 percent on cash equity and from 5.1 percent to 7.9 percent on total equity. However, in the construction year and the first two years of operation the rates of return would be lower under the Treasury tax proposal as compared to the existing tax provisions.

2. Proceeds from Sale of Property. For the purpose of this analysis it is assumed that each apartment house is sold one day after the 10th year of operation at a price equal to its original appraised value. Table 7 shows the calculations of net cash proceeds from the respective sale, taking account of the different rules of the Internal Revenue Code governing the recapture of "excess depreciation." The tax law regards the accelerated depreciation (on "Section 1250 property") in excess of straight-line

depreciation as "excess depreciation," which may be taxed at the taxpayer's regular tax rate or his capital gains tax rate (half of his regular tax rate), depending upon how long he holds the property.

In the case of the Section 236 project (which qualifies as low and moderate income housing), after 10 years of operation the entire gain from sale of the property is taxable at the more favorable capital gains tax rate. For the conventionally financed project, after 10 years of operation, only 20 percent of the gain attributable to excess depreciation plus the gain attributable to straight line depreciation, is taxed at the more favorable capital gains rate. The remaining 80 percent of the gain attributable to "excess depreciation" is taxed at the investor's regular tax rate.

Table 7 details the respective caculations of net cash proceeds from sale of the property under the existing tax provisions (which remain in tack under the Treasury tax proposals where investors have "net related income") and under the Treasury tax proposals where the investors do not have any "net related income" which can be sheltered by the tax losses from the projects excess depreciation.

Under existing tax provisions, the total gain from sale of the Section 236 project is $822,080, compared to $955,080 for the conventionally financed project, the difference of $133,000 reflecting the higher initial appraised value and assumed sales price. The owners of the Section 236

project pay a total Federal tax of $205,520, compared to taxes of $287,185 that are paid by the owners of the conventionally financed project. With respect to the latter, around $48,000 of the higher tax may be attributable to the different rules governing recapture of excess depreciation. After allowing for the outstanding loan and payment of Federal income taxes, the net cash proceeds from the sale of the Section 236 project are $113,177, or $13,177 more than the owners' initial cash equity. For the conventionally financed project, the net cash proceeds come to $521,988, or $221,988 more than the owners' initial cash equity.

Under the Treasury tax proposal the computations for the conventionally financed project are the same as those calculated for the project under the existing tax provisions because the investor-taxpayer has used up his accumulated tax losses in the Deferred Loss Account by the end of the 10th operating year. Thus, the total gain from sale is $955,080, the Federal tax liability is $287,186 and the net cash proceeds are $521,988.

In contrast, for the Section 236 project the Treasury tax proposals result in substantial changes - the gain from the sale drops from $822,080 to $500,000, the Federal tax liability decreases from $205,520 to $125,000 and the net cash proceeds increases from $113,177 to $193,697. As depicted in Table 7, all three changes are attributable to the deduction of $322,080 in the Deferred Loss Account from the Unadjusted Basis in order to caculate the Adjusted Basis, that is, the amount to be subtracted from the sales

price to determine the taxable gain.

3. Rates of Return. Table 8 compares the rates of return on the four housing properties arising from: (a) the operating cash flow, plus tax shelter, and (b) the net proceeds from the sale of the properties at the end of 10 years of operation. Inasmuch as there are no uniform methods for measuring rates of return in the real estate industry, four measurements of rates of return are shown: (a) the average cash return on cash equity, (b) the average return on total equity, (c) the discounted rate of return on cash equity and (d) the discounted rate of return on total equity.

(a) In measuring their rates of return on investments, some investors contrast their cash receipts with their initial cash investment without regard to any other equity they may hold in the property investment. In making this comparison they allow for recouping their initial cash investment (usually at the time or property sale) by subtracting it from their total cash receipts. Hence, the average cash return is equal to the total operating cash flow plus tax shelter during the investors' holding period less their cash equity investment divided by the number of years in the holding period. This average cash return is then divided by the cash equity to obtain the first measure.

(b) Other investors measure their rates of return by contrasting cash receipts with their total equity investment, both cash and non-cash equity.

These investors expect to recoup both their cash and non-cash equity investments as well as earn a return. In calculating their rates of return these investors subtract both their cash and non-cash equity investments from their total cash receipts plus tax shelter in order to arrive at a "net return." This "net return" is then divided by the number of years in the holding period to obtain an average return. The average return is then divided by the total equity investment (cash plus non-cash) to calculate the average return on total equity.

(c) and (d) Both of the above average rates of return give equal weight to earnings irrespective of the year in which they occur. Since a dollar of income earned in the first year has a greater present value to an investor than a dollar earned 10 years from now, some investors seek to "equalize" their earnings by discounting the stream of future incomes over the period in which they hold the property into present values. By discounting such incomes at the investors' internal rate of return (the interest rate that equates the present values of the future incomes with the amount of the investment), appropriate allowance is made for the investor recouping his equity investment in addition to earning a return. Separate discounted rates of return have been calculated for both cash equity and total equity.

These measurements of rates of return are as follows:

Rate of Return Measurement	Existing Tax Provisions: Section 236 Project	Existing Tax Provisions: Conventionally Financed Project	Treasury Tax Proposals: Section 236 Project	Treasury Tax Proposals: Conventionall Financed Project
a) Average rate of return on owners' cash equity	30.2%	18.4%	22.9%	18.4%
b) Average rate of return on owners' total equity	10.5%	6.4%	6.9%	6.4%
c) Discounted rate of return on owners' cash equity	34.5%	15.6%	16.9%	14.3%
d) Discounted rate of return on owners' total equity	13.9%	6.7%	6.8%	6.3%

As will be noted, as compared to existing tax provisions, under the Treasury tax proposals there would be a sharp reduction in the rates of return for the Section 236 project, irrespective of the measurement employed. For the conventionally financed project there would be no change at all for the two average rates of return and a slight decrease in the two discounted rates of return. The latter reflects a different time path for the cash returns and tax benefits. (see Tables 4 and 6)

4. Rent Adjustments to Increase Rate of Return. The sharp reduction in the rates of return on Section 236 projects described above would render them unattractive to investors with no "net related income" which probably would lead to a dry-up of private funds for low and moderate income housing. If such private investment in Section 236 housing (or a similar Federal program involving limited dividend sponsors) is deemed vital, and the Treasury tax

proposals were enacted, higher rates of return could, nonetheless, be achieved by increasing the cash returns. Larger cash returns would result in higher rents.

Table 9 measures the increase in tenant rentals that would be needed to produce the rate of return now obtainable on Section 236 projects. It is assumed that the investors are in the 50 percent tax bracket without any "net related income" from non-project sources.

Increasing the average rate of return on the owners' cash equity from the 22.9 percent per year shown in the preceding section to the 30.2 percent per year presently obtainable under existing tax provisions would require an increase in the monthly rental by $5.65 to $185.86. This rental is 3 percent higher than the $180.21 rent charged under existing tax provisions.

Table 1

Basic Assumptions

	Type of Financing	
	FHA Sec. 236	Conventional
1. Appraised Value	$2,000,000	$2,133,000 1/
2. Total Development Cost (TDC)	2,000,000	2,000,000
Cost expensed during construction 2/	80,000	80,000
Depreciable construction cost 3/	1,600,000	1,600,000
Builders' and Sponsors' Profit and Risk	100,000	233,000
For construction and development 3/	100,000	100,000
Higher appraisal	--	133,000 1/
Land Cost 4/	220,000	220,000
Number of Units	125	125
Appraised Value per Unit	16,000	17,100
3. Mortgage Terms 5/		
Loan to value ratio	90%	75%
Repayment period	40 years	25 years
Interest rate	7%	9%
Mortgage loan amount	1,800,000	1,600,000
4. Total Book Equity 6/	200,000	533,000
Cash equity 7/	100,000	300,000
Non-cash equity	100,000	233,000

1/ Appraised value exceeds total development cost by $133,000--the amount needed to accommodate the two assumptions of (a) cash equity at 15% of total development cost and (b) a 75% conventional loan. Generally, prospective owners are reluctant to invest in a conventionally financed new construction project, unless the appraised value resulting from capitalization of projected net rental income exceeds the total development cost.

2/ According to the Touche Ross study, about 4% of total development costs are "expensed" (taken as tax deductions) during the construction period.

3/ According to the Touche Ross study, costs attributable to "depreciable cost" are about 85% of total development cost. It is assumed that this is broken down into depreciable construction cost of $1.6 million (80%) and unrealized "builders' and sponsors' profit and risk" of $100,000 (5%).

(Table 1 continued)

4/ Eleven percent of total development cost, based on Touche Ross study.

5/ The terms for the conventional mortgage loan are based on recent life insurance company experience.

6/ Total book equity equals appraised value less outstanding mortgage loan.

7/ For Section 236 project, assumed to be 5% of total development cost and for conventionally financed project assumed to be 15% (based on Touche Ross study).

Table 2

Rent and Revenue Schedules

	FHA Section 236		Conventional
	Basic Rent	Market Rent	Financing
1. Per Unit Rent Schedules (monthly basis)			
Maintenance & Operating Expenses[1/]	$ 44.00	$ 44.00	$ 44.00
Property Taxes[1/]	18.00	18.00	18.00
Debt Service & M.I.P.	36.40[2/]	94.80[3/]	107.40[4/]
Replacement Reserve[5/]	6.40	6.40	6.40
Cash Return	8.00[6/]	8.00[6/]	28.00[7/]
Net Rent	$112.80	$171.20	$203.80
Occupancy Rate	95%	95%	95%
Gross Rent	$118.74	$180.21	$214.53
2. Tenant Income Class Served			
Annual Gross Rent	$ 1,425	$ 2,163	$ 2,574
Family Income[8/]	5,700	8,652	10,296
3. Gross Revenues - Project (annual basis)			
Net Rental Receipts	$169,200	$256,800	$305,700
HUD Interest Subsidy	87,600		
Total Gross Revenues	$256,800	$256,800	$305,700

1/ Based on Touche Ross study showing average costs for low-moderate and middle rent levels. Monthly maintenance expense is calculated at $11 per dwelling unit and monthly operating expense at $33 per dwelling unit.

2/ At 1% interest, 40 years on $14,400 per unit loan.

3/ At 7% interest plus mortgage insurance premium, 40 years on $14,400 per unit loan.

4/ At 9% interest, 25 years on a $12,800 loan.

5/ Based on annual rate of .0060 times depreciable cost.

6/ 6% return on book equity.

7/ Touche Ross Appendices Schedule 8. Net cash return 14% of cash equity.

8/ At a 25% rent-to-income ratio.

Table

Cash Flow and Tax Benefits For Section 236 Project
Under Existing Tax Provisions (Investors Have Other "Net Related Income")

	Construction Year	Operating Years 1	2	3	4	5	6	7	8	9	10
A. Cash Flow											
Receipts											
Tenant Receipts 1/		$169,200	$169,200	$169,200	$169,200	$169,200	$169,200	$169,200	$169,200	$169,200	$169,200
Interest Reduction Payment 2/		87,600	87,530	87,490	87,440	87,380	87,320	87,260	87,190	87,120	87,040
Total Revenue		256,800	256,730	256,690	256,640	256,580	256,520	256,460	256,390	256,320	256,240
Outlays											
M&O plus Real Estate Taxes 1/		93,000	93,000	93,000	93,000	93,000	93,000	93,000	93,000	93,000	93,000
Debt Service & MIP 3/		142,200	142,130	142,090	142,040	141,980	141,920	141,860	141,790	141,720	
Replacement Reserve		9,600	9,600	9,600	9,600	9,600	9,600	9,600	9,600	9,600	9,600
Federal Income Taxes		---	---	---	---	---	---	---	---	---	---
Cash Return		12,000	12,000	12,000	12,000	12,000	12,000	12,000	12,000	12,000	12,000
B. Tax Benefits											
Total Revenue		256,800	256,730	256,690	256,640	256,580	256,520	256,460	256,390	256,320	256,240
Deductible Expenses											
M&O plus Real Estate Taxes 1/		93,000	93,000	93,000	93,000	93,000	93,000	93,000	93,000	93,000	93,000
Interest Expense & MIP		134,730	134,050	133,350	132,590	131,770	130,900	129,970	128,970	127,900	126,740
Taxable Income Before Depreciation	$(-80,000)	29,070	29,680	30,340	31,050	31,810	32,620	33,490	34,420	35,420	36,500
Straight Line Depreciation		40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000
Taxable Income After S.L. Depr.	(-80,000)	(-10,930)	(-10,320)	(-9,660)	(-8,950)	(-8,190)	(-7,380)	(-6,510)	(-5,580)	(-4,580)	(-3,500)
Excess Depreciation 4/		40,000	26,000	32,160	28,640	25,120	21,920	18,880	15,840	13,120	10,400
Taxable Income (or Loss)	(-80,000)	(-50,930)	(-46,320)	(-41,820)	(-37,590)	(-33,310)	(-29,300)	(-25,390)	(-21,420)	(-17,700)	(-13,900)
Federal Tax (50% bracket)	(-40,000)	(-25,465)	(-23,160)	(-20,910)	(-18,795)	(-16,655)	(-14,650)	(-12,695)	(-10,710)	(- 8,850)	(- 6,950)
Artificial Loss 5/	----	---	---	---	---	---	---	---	----	---	---
Deferred Loss Account 6/	----	---	---	---	---	---	---	---	---	---	---
C. Cash Flow plus Tax Benefits	40,000	37,465	35,160	32,910	30,795	28,655	26,650	24,695	22,710	20,850	18,950
D. Percent Cash Flow Plus Tax Benefit to Cash Equity	40.0%	37.5%	35.2%	32.9%	30.8%	28.7%	26.7%	24.7%	22.7%	20.9%	19.0%
E. Percent Cash Flow Plus Tax Benefit to Total Equity	20.0%	18.7%	17.6%	16.5%	15.4%	14.3%	13.3%	12.3%	11.4%	10.4%	9.5%

1/ Tenant rental receipts, maintenance and operating expenses, and real estate taxes assumed to be constant during the 10 year operating period.

2/ Debt Service payment (including mortgage insurance premium) paid by HUD to the mortgagee on behalf of the mortgagor.

3/ Decreasing amounts reflect smaller mortgage insurance premiums (MIP) as the outstanding loan balance declines.

4/ Excess depreciation equals the difference between accelerated depreciation and straight line depreciation. Both assume 40 year remaining useful life.

5/ Artificial loss includes pre-operation costs during construction period and "excess depreciation" not used by investor-taxpayer against his other "net related income".

6/ Deferred Loss Account is the accumulation of artificial losses that may be drawn upon to shelter "net related income" in future years if it arises.

Table 4

Cash Flow and Tax Benefits For Conventionally Financed Project
Under Existing Tax Provisions (Investors Have Other "Net Related Income")

	Construction Year	Operating Years 1	2	3	4	5	6	7	8	9	10
A. Cash Flow											
New Rental Receipts 1/		$305,700	$305,700	$305,700	$305,700	$305,700	$305,700	$305,700	$305,700	$305,700	$305,700
Outlays:											
M&O plus Real Estate Taxes 1/		93,000	93,000	93,000	93,000	93,000	93,000	93,000	93,000	93,000	93,000
Debt Service		161,100	161,100	161,100	161,100	161,100	161,100	161,100	161,100	161,100	161,100
Replacement Reserve		9,600	9,600	9,600	9,600	9,600	9,600	9,600	9,600	9,600	9,600
Federal Income Taxes		---	---	385	3,145	6,005	8,800	11,630	14,585	17,515	20,590
Cash Return		42,000	42,000	41,615	38,855	35,995	33,200	30,370	27,415	24,485	21,410
B. Tax Benefits											
Tenant Rental Receipts 1/		306,700	305,700	305,700	305,700	305,700	305,700	305,700	305,700	305,700	305,700
Deductible Expenses:											
M&O plus Real Estate Taxes 1/		93,000	93,000	93,000	93,000	93,000	93,000	93,000	93,000	93,000	93,000
Interest Expense		143,280	141,600	139,770	137,770	135,570	133,180	130,560	127,690	124,550	121,120
Taxable Income Before Depreciation	$(-80,000)	69,420	71,100	72,930	74,930	77,130	79,520	82,140	85,010	88,150	91,580
Straight Line Depreciation		40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000
Taxable Income After S.L. Depr.	(80,000)	29,420	31,100	32,930	34,930	37,130	39,520	42,140	45,010	48,150	51,580
Excess Depreciation 2/		40,000	36,000	32,160	28,640	25,120	21,920	18,880	15,840	13,120	10,400
Taxable Income (or Loss)	(-80,000)	(-10,580)	(- 4,900)	770	6,290	12,010	17,600	23,260	29,170	35,030	41,180
Federal Tax (50% bracket)	(-40,000)	(- 5,290)	(- 2,450)	385	3,145	6,005	8,800	11,630	14,585	17,515	20,590
Artificial Loss 3/	----	----	----								
Deferred Loss Account 4/	----	----	----								
C. Cash Flow plus Tax Benefits	40,000	47,290	44,450	41,615	38,855	35,995	33,200	30,370	27,415	24,485	21,410
D. Percent Cash Flow plus Tax Benefit to Cash Equity	13.3%	15.8%	14.8%	13.9%	13.0%	12.0%	11.1%	10.1%	9.1%	8.2%	7.1%
E. Percent Cash Flow plus Tax Benefit to Total Equity	7.5%	8.9%	8.3%	7.8%	7.3%	6.8%	6.2%	5.7%	5.1%	4.6%	4.0%

1/ Tenant rental receipts, maintenance and operating expenses, and real estate taxes assumed to be constant during the 10 year operating period.

2/ Excess depreciation equals the difference between accelerated depreciation and straight line depreciation. Both assume 40 year remaining useful life.

3/ Artificial loss includes pre-operation costs during construction period and "excess depreciation" not used by investor-taxpayer against his other "net related income".

4/ Deferred Loss Account is the accumulation of artificial losses that may be drawn upon to shelter "net related income" in future years if it arises.

Cash Flow and Tax Benefits For Section 236 Project Where Investors Do Not Have Other "Net Related Income"

	Construction Year	Operating Years 1	2	3	4	5	6	7	8	9	10
A. Cash Flow											
Receipts											
Tenant Receipts 1/		$169,200	$169,200	$169,200	$169,200	$169,200	$169,200	$169,200	$169,200	$169,200	$169,200
Interest Reduction Payment 2/		87,600	87,530	87,490	87,440	87,380	87,320	87,260	87,190	87,120	87,040
Total Revenue		256,800	256,730	256,690	256,640	256,580	256,520	256,460	256,390	256,320	256,240
Outlays:											
M&O plus Real Estate Taxes 1/		93,000	93,000	93,000	93,000	93,000	93,000	93,000	93,000	93,000	93,000
Debt Service & MIP 3/		142,200	142,130	142,090	142,040	141,980	141,920	141,860	141,790	141,720	
Replacement Reserve		9,600	9,600	9,600	9,600	9,600	9,600	9,600	9,600	9,600	9,600
Federal Income Taxes		---	---	---	---	---	---	---	---	---	---
Cash Return		12,000	12,000	12,000	12,000	12,000	12,000	12,000	12,000	12,000	12,000
B. Tax Benefits											
Total Revenue		256,800	256,730	256,690	256,640	256,580	256,520	256,460	256,390	256,320	256,240
Deductible Expenses											
M&O plus Real Estate Taxes 1/		93,000	93,000	93,000	93,000	93,000	93,000	93,000	93,000	93,000	93,000
Interest Expense & MIP		134,730	134,050	133,350	132,590	131,770	130,900	129,970	128,970	127,900	126,740
Taxable Income Before Depreciation	$(-80,000)	29,070	29,680	30,340	31,050	31,810	32,620	33,490	34,420	35,420	36,500
Straight Line Depreciation		40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000
Taxable Income After S.L. Depr.		(-10,930)	(-10,320)	(- 9,660)	(- 8,950)	(- 8,190)	(- 7,380)	(- 6,510)	(- 5,580)	(- 4,580)	(- 3,500)
Excess Depreciation 4/		40,000	36,000	32,160	28,640	25,120	21,920	18,880	15,840	13,120	10,400
Taxable Income (or Loss)		(-10,930)	(-10,320)	(- 9,660)	(- 8,950)	(- 8,190)	(- 7,380)	(- 6,510)	(- 5,580)	(- 4,580)	(- 3,500)
Federal Tax (50% bracket)		(- 5,465)	(- 5,160)	(- 4,830)	(- 4,475)	(- 4,095)	(- 3,690)	(- 3,255)	(- 2,790)	(- 2,290)	(- 1,750)
Artificial Loss 5/	80,000	40,000	36,000	32,160	28,640	25,120	21,920	18,880	15,840	13,120	10,400
Deferred Loss Account 6/	80,000	120,000	156,000	188,160	216,800	241,920	263,840	282,720	298,560	311,680	322,080
C. Cash Flow plus Tax Benefits	---	17,465	17,160	16,830	16,475	16,095	15,690	15,255	14,790	14,290	13,750
D. Percent Cash Flow plus Tax Benefit to Cash Equity	---	17.5%	17.2%	16.8%	16.5%	16.1%	15.7%	15.3%	14.8%	14.3%	13.8%
E. Percent Cash Flow plus Tax Benefit to Total Equity	---	8.7%	8.6%	8.4%	8.2%	8.0%	7.8%	7.6%	7.4%	7.1%	6.9%

1/ Tenant rental receipts, maintenance and operating expenses, and real estate taxes assumed to be constant during the 10 year operating period.

2/ Debt Service payment (including mortgage insurance premium) paid by HUD to the mortgagee on behalf of the mortgagor.

3/ Decreasing amounts reflect smaller mortgage insurance premiums (MIP) as the outstanding loan balance declines.

4/ Excess depreciation equals the difference between accelerated depreciation and straight line depreciation. Both assume 40 year remaining useful life.

5/ Artificial loss includes pre-operation costs during construction period and "excess depreciation" not used by investor-taxpayer against his other "net related income".

6/ Deferred Loss Account is the accumulation of artificial losses that may be drawn upon to shelter "net related income" in future years if it arises.

Table 6

Cash Flow and Tax Benefits For Conventionally Financed Project
Where Investors Do Not Have Other "Net Related Income"

	Construction Year	Operating Years 1	2	3	4	5	6	7	8	9	10
A. Cash Flow											
Net Rental Receipts 1/		$305,700	$305,700	$305,700	$305,700	$305,700	$305,700	$305,700	$305,700	$305,700	$305,700
Outlays:											
M&O plus Real Estate Taxes 1/		93,000	93,000	93,000	93,000	93,000	93,000	93,000	93,000	93,000	93,000
Debt Service		161,100	161,100	161,100	161,100	161,100	161,100	161,100	161,100	161,100	161,100
Replacement Reserve		9,600	9,600	9,600	9,600	9,600	9,600	9,600	9,600	9,600	9,600
Federal Income Taxes		---	---	---	---	---	---	---	---	14,325	20,590
Cash Return		42,000	42,000	42,000	42,000	42,000	42,000	42,000	42,000	27,675	21,410
B. Tax Benefits											
Tenant Rental Receipts 1/		305,700	305,700	305,700	305,700	305,700	305,700	305,700	305,700	305,700	305,700
Deductible Expenses:											
M&O plus Real Estate Taxes 1/		93,000	93,000	93,000	93,000	93,000	93,000	93,000	93,000	93,000	93,000
Interest Expense		143,280	141,600	139,770	137,770	135,570	133,180	130,560	127,690	124,550	121,120
Taxable Income Before Depreciation	$(-80,000)	69,420	71,100	72,930	74,930	77,130	79,520	82,140	85,010	88,150	91,580
Straight Line Depreciation		40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000	40,000
Taxable Income After S.L. Depr.		29,420	31,100	32,930	34,930	37,130	39,520	42,140	45,010	48,150	51,580
Excess Depreciation 2/		40,000	36,000	32,160	28,640	25,120	21,920	18,880	15,840	13,120	10,400
Taxable Income (or Loss)		---	---	770	6,290	12,010	17,600	23,260	29,170	35,030	41,180
Federal Tax (50% bracket)		---	---	---	---	---	---	---	---	14,325	20,590
Artificial Loss 3/	80,000	10,580	4,900	(- 770)	(- 6,290)	(-12,010)	(-17,600)	(-23,260)	(-29,170)	(- 6,380)	---
Deferred Loss Account	80,000	90,580	95,480	94,710	88,420	76,410	58,810	25,550	6,380	---	---
C. Cash Flow plus Tax Benefits	---	42,000	42,000	42,000	42,000	42,000	42,000	42,000	42,000	27,675	21,410
D. Percent Cash Flow plus Tax Benefit to Cash Equity	---	14.0%	14.0%	14.0%	14.0%	14.0%	14.0%	14.0%	14.0%	9.2%	7.1%
E. Percent Cash Flow plus Tax Benefit to Total Equity	---	7.9%	7.9%	7.9%	7.9%	7.9%	7.9%	7.9%	7.9%	5.2%	4.0%

1/ Tenant rental receipts, maintenance and operating expenses, and real estate taxes assumed to be constant during the 10 year operating period.

2/ Excess depreciation equals the difference between accelerated depreciation and straight line depreciation. Both assume 40 year remaining useful life.

3/ Artificial loss includes pre-operation costs during construction period and "excess depreciation" not used by investor-taxpayer against his other "net related income".

4/ Deferred Loss Account is the accumulation of artificial losses that may be drawn upon to shelter "net related income" in future years if it arises.

Tabl

Net Proceeds From the Sales of the Apartment Buildings
Assuming 10-Year Holding Period and Sales Price
Equal to Original Appraised Value

	Existing Tax Provisions*		Proposed Tax Changes No Related Income	
	Section 236	Conventional	Section 236	Conventional
Determination of Gain				
1. Unadjusted Basis				
Appraised Value	$ 2,000,000	$ 2,133,000	$ 2,000,000	$ 2,133,000
Less: Builders & Sponsors Profit and Risk 1/	100,000	233,000	100,000	233,000
Costs Expensed	80,000	80,000	80,000	80,000
Unadjusted Basis	1,820,000	1,820,000	1,820,000	1,820,000
Depreciation Basis (structure)	1,600,000	1,600,000	1,600,000	1,600,000
Non-Depreciation Basis (land)	220,000	220,000	220,000	220,000
2. Additional Depreciation				
Depreciation Taken	642,080	642,080	642,080	642,080
Depreciation	400,000	400,000	400,000	400,000
Additional ("Excess") Depreciation	242,080	242,080	242,080	242,080
3. Adjusted Basis				
Unadjusted Basis	1,820,000	1,820,000	1,820,000	1,820,000
Less Depreciation Taken 3/	642,080	642,080	642,080	642,080
Plus Deferred Loss Account	--	--	322,080	--
Adjusted Basis	1,177,920	1,177,920	1,500,000	1,177,920
4. Gain				
Sales Price	2,000,000	2,133,000	2,000,000	2,133,000
Less Adjusted Basis	1,177,920	1,177,920	1,500,000	1,177,920
Taxable Gain	822,080	955,080	500,000	955,080

Table 9 (Cont.)

	Existing Tax Provisions*		Proposed Tax Changes	
	Section 236	Conventional	No Related Section 236	Conventional
B. Determination of Tax Liability				
Total Taxable Gain	$ 822,080	$ 955,080	$ 500,000	$ 955,080
1. Tax at Regular Tax Rate - Gain subject to recapture at regular income tax rate				
Recapture Basis	-- 4/	193,664 5/	-- 4/	193,664 5/
Recapture Tax (50% income tax bracket)	--	96,832	--	96,832
2. Tax at Capital Gains Rate				
Total Gain	822,080	955,080	500,000	955,080
Less Recapture Gain	--	193,664	--	193,664
Gain Subject to Capital Gains	822,080	761,416	500,000	761,416
Capital Gains Deduction (50 percent)	411,040	380,708	250,000	380,708
Capital Gains Tax (50 percent income tax bracket)	205,520	190,354	125,000	190,354
3. Federal Taxes				
Recapture	--	96,832	--	96,832
Capital Gains	205,520	190,354	125,000	190,354
Subtotal	205,520	287,186	125,000	287,186
Amount Subject to Minimum Taxable Income	411,040	380,708	250,000	380,708
Amount Subject to Minimums Tax (Tax Preference Item)	N/A	N/A	N/A	N/A
C. Net Proceeds From Sale				
Sales Price	2,000,000	2,133,000	2,000,000	2,133,000
Less Outstanding Mortgage	1,681,303	1,323,826	1,681,303	1,323,826
Less Federal Taxes	205,520	287,186	125,000	287,186
Net Cash Proceeds	113,177	521,988	193,697	521,988

* Also under Treasury tax proposal where investors have "net related income."

Footnotes:

1/ Because "income was not realized by the builder and sponsor at the time of construction for their profit and risk, the non-cash equity cannot be included in the unadjusted basis for the determination of capital gain.

2/ Considered expenses even if added to the deferred loss account. To the extent there is a balance in the deferred loss account at time of property disposition, the adjusted basis will be increased.

3/ Deferred loss account is added to the adjusted basis of the property unless it would create or increase a capital loss on the sale.

4/ Section 1250 (a)(1)(c) (ii): 100% - (120-20) = 0%; i.e., all gain on Section 236 property is subject to capital gains treatment after 10 years.

5/ Section 1250(a)(1)(c)(iii): 100% - (120-100) = 80% times excess depreciation of $242,080.

Analysis of [illegible] of Return

	Existing Tax Provisions		Treasury Tax Proposal No Related Income	
	Section 236	Conventional	Section 236	Conventional
Stream of Income (Cash Flow plus Tax Shelter)				
Construction Period	$ 40,000	$ 40,000	--	--
Operating Years - 1	37,465	47,290	$ 17,465	$ 42,000
2	35,160	44,450	17,160	42,000
3	32,910	41,615	16,830	42,000
4	30,795	38,855	16,475	42,000
5	28,655	35,995	16,095	42,000
6	26,650	33,200	15,690	42,000
7	24,695	30,370	15,255	42,000
8	22,710	27,415	14,790	42,000
9	20,850	24,485	14,290	27,675
10	18,950	21,410	13,750	21,410
Sale of Property 1/	113,177	521,988	193,697	521,988
Sum	432,017	907,073	351,497	907,073
Average Rate of Return				
1. Operating Cash Flow	120,000	337,345	120,000	385,085
2. Plus Tax Shelter	198,840	47,740	37,800	--
3. Plus Net Proceeds from Sale	113,177	521,988	193,697	521,988
4. Total Cash Return from Property	432,017	907,073	351,497	907,073
5. Cash Equity Foregone	- 100,000	- 300,000	- 100,000	- 300,000
6. Net Cash Return	332,017	607,073	251,497	607,073
7. Non-Cash Equity Foregone	- 100,000	- 233,000	- 100,000	- 233,000
8. Net Return	$ 232,017	$ 374,073	$ 151,497	$ 374,073

1/ Sales price less Federal taxes and outstanding mortgage loan.

Table 8 (Cc)

	Existing Tax Provisions		Treasury Tax Proposal No Related Income	
	Section 236	Conventional	Section 236	Conventional
9. Average Cash Return (line 6 ÷ 11 years)	$ 30,183	$ 55,188	$ 22,863	$ 55,188
10. Average Return (line 8 ÷ 11 years)	21,092	34,007	13,772	34,007
11. Average Cash Return on Cash Equity (line 9 ÷ line 5)	30.2%	18.4%	22.9%	18.4%
12. Average Return on Total Equity (line 10 ÷ by the sum of line 5 plus line 7)	10.5%	6.4%	6.9%	6.4%
Discounted Rate of Return				
On Cash Equity	34.5%	15.6%	16.9%	14.3%
On Total Equity	13.9%	6.7%	6.8%	6.3%

Table 9

Estimated Increase in Rents.
Required to Achieve Previous Rate of Return

		To Achieve Existing Sec. 236 Return
1.	Average Rate of Return on Cash Equity (Target Rate)	30.2%
2.	Average Cash Return Needed 1/	$33,202
3.	Actual Average Cash Return 1/	25,149
4.	Annual Shortfall in Average Cash Return	8,053
5.	Shortfall Per Unit Per Month	5.37
6.	Present Per Unit Market Rent	171.20
7.	Required Per Unit Market Rent	176.57
8.	Assumed Occupancy Rate	95%
9.	Required Per Unit Gross Rent	185.86
10.	Present Per Unit Gross Rent	180.21
11.	Increase in Gross Rent Required to Achieve Target Rate of Return	5.65

1/ Average annual cash return over a ten year period, including cash return from operations, net proceeds from sale and value of tax benefits arising from applying tax losses during project operations.

Appendix C.

Tax Reform and Tax Credits

ABSTRACT: This paper evaluates proposals to substitute various kinds of tax credits for the existing tax incentives. It highlights some of the advantages and disadvantages of this kind of reform.

Discussion Draft No. 2 Date 6/22/73

Team No. IV
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TAX REFORM AND TAX CREDITS

by Craig Stapleton

Introduction

Virtually every policymaker interested in housing and economic development over the past decade has envisioned a role for the American corporation. While there has been wide agreement that corporations' efforts would be instrumental in revitalizing poverty areas, the rationale and design for that involvement has changed over time as both policymakers and the corporations themselves have reviewed the profit potential and risks, as well as the demands on corporations' energies and skills inherent in housing and economic development programs.

In the mid-1960's, the argument for business involvement in the cities, was that the cities were critical to the long run prosperity of business. Therefore, business should be willing in the short run to put aside its profit making objective in order to serve the longer term objective of maintaining a stable society. This was really an extension of the historical division within the corporate enterprise of profit and charity. It meant simply that the term charity had to be extended to include a broader range of activities.

In the late 1960's the emphasis of encouraging corporate involvement moved toward the profit side. The Johnson Administration in the manpower field was coming to the conclusion that to get business to help train workers, there had to be

profit in it for business. During the same period, Senator Robert Kennedy was attempting to structure legislation which would make it attractive to corporations to participate in housing and economic development in poverty areas. The belief was that corporations were a critical vehicle in attacking any problem -- economic or social-- and to enlist their active participation the profit motive had to be built upon. It was not contemplated that business would replace government, although the advantage of not creating a new bureaucracy was argued, but rather that there should be a partnership between government and the private sector to attack the problems of housing and economic development. The use of the tax system was a critical component in each of these programmatic approaches. Ultimately, two key programs for corporate involvement evolved for corporate activities -- the National Corporation for Housing Partnerships, which was devised to take advantage of the existing tax laws, and Breakthrough. This paper will focus on existing and proposed tax incentives, and their respective impacts on individual and corporate involvement in federal programs for economic development and housing.

Economic Development

In economic development, no role has ever been structured for corporations. Senators Robert Kennedy and James Pearson sponsored a bill S-2088 in 1967[1/], which was designed to create jobs in poverty areas by providing investment credits to corporations locating industrialized plants and other service buildings in the poverty areas. The only businesses which qualified agreed to hire at least 20 workers of whom at least 2/3 were to be low-income residents of the relevant poverty area or low-income unemployed persons. S. 2088 did not provide any special mechanism for financing these businesses, as it was felt that corporate financing was available without federal inducements. The incentives were to apply only to new facilities, not the relocation of old facilities. The qualifying areas were restricted initially to 193 urban poverty areas identified by OEO (with an exception for Indian reservations and as amended to include rural poverty areas). The bill would apply only to manufacturers, producers, and distributors, not retailers.

The incentives were to be as follows:

1/ Senator Pearson introduced a bill (S. 1475) on April 5, 1973 to allow a double investment credit for certain property placed in service in rural areas which will assist in providing new employment opportunities. There are no restrictions on the number of job opportunities. The only restriction is that the property be used in the manufacturing, processing, assembling or distribution of personal property

(1) 10% credit on machinery and equipment, in lieu of the normal maximum 7%
(2) 7% credit on expenditures for constructing an industrial facility or for leasing space for a qualifying business.
(3) a credit carryback of three taxable years, and a carryover of 10 taxable years.
(4) a useful life for purposes of depreciation of 66 2/3% of the normal useful life applicable to real and personal property.
(5) a net operating loss carryover of 10 years.
(6) a special deduction of an additional 25% of the salaries paid to all workers hired to meet the requirement of S. 2088.

This program was never implemented. Moreover, what programs exist for economic development have not relied on the tax structures. While the Economic Development Administration has created some of the underpinnings for economic growth in poverty areas, it has not for the most part, sought the participation of corporations of the type Kennedy envisaged. The Minority Enterprise Small Business Investment Corporation (MESBIC) has attracted small amounts of corporate capital, but has not sought to involve the corporation in the economic development activities of MESBICs. Without any incentives to participate in economic development, corporations never went through the analysis of what return they would expect in order to take the risks inherent in most economic development activities. Corporations neither examined their organizational structure to decide if this activity required rearrangement, nor did they analyze their management skills to see if they were sufficient for economic development activities.

Housing - The Kennedy-Smathers Proposal (S-2100)

Senator Robert Kennedy together with Senator George Smathers introduced in 1967 a bill (S-2100) explicitly to encourage corporations to develop low income housing in urban poverty areas, (amended to include rural areas). The bill offered corporations an investment tax credit for qualifying housing on a sliding scale depending on the amount of equity the corporation invested, but not less than 20% of project cost. Subsequent holders were also eligible for investment credits.

Investment credit

	1st holder	Subsequent holder
20 to 25	3.0	2.0
25 to 30	5.0	3.0
30 to 35	6.5	4.0
35 to 40	8.0	5.0
40 to 45	9.5	7.5
45 to 50	11.0	10.0
50 to 55	12.0	12.0
55 to 60	13.0	13.0
60 to 65	14.0	14.0
65 to 70	15.0	15.0
70 to 75	16.0	16.0
75 to 80	17.0	17.0
80 to 85	18.0	18.0
85 to 90	19.0	19.0
90 to 95	20.0	20.0
95 to 100	21.0	21.0
100 or more	22.0	22.0

The larger the corporate equity investment, the larger the tax credit. The objective of this scale was to encourage higher equity investment in order to preserve the mortgage pool and thus build more units. The tax credit was based on project replacement cost, rather than the equity investment itself. The tax credit could be carried forward as much as 7 years, or carried back as far as 3 years. The bill hoped to encourage large corporations with substantial cash reserves to invest in housing much as they would in other plant and equipment.

In addition, depreciable lives would be reduced to a percentage of the lives that otherwise would have been allowable, i.e., a faster write-off than conventional real estate. The percentage would vary inversely with the percentage of the owners equity in the project.

Percentages of Useful Life Based On Equity Investment

Equity Investment %	First Holder	Subsequent Holder
Less than 10%	None	75%
10% or more but less than 20%	None	55%
20% or more but less than 25%	40%	40%
25% or more but less than 30%	36%	39%
30% or more but less than 35%	32%	38%
35% or more but less than 40%	28%	37%
40% or more but less than 45%	25%	36%
45% or more but less than 50%	22%	35%
50% or more but less than 55%	20%	34%
55% or more but less than 60%	19%	33%
60% or more but less than 65%	18%	32%
65% or more but less than 70%	17.5%	31%
70% or more but less than 75%	17%	30%
75% or more but less than 80%	16.5%	29%
80% or more but less than 85%	16%	28%
85% or more but less than 90%	15.5%	27%

The third principal tax advantage of the proposal was that capital gains tax would be waived if the owner sold the building to a Tenants' Council after 8-10 years or if the owner sold the project and reinvested the proceeds in another low income housing project. Also, any capital gain would be reduced after a minimum holding period ranging from 7-10 years. Finally, there was provision that after a building was fully depreciated, the owner could elect to treat the building as having been sold to himself at a specified price. This would enable the same owner to begin a new depreciation schedule.[2/]

2/ The other tax provisions were of lesser significance:
(1) Permitting demolition costs and site improvements to be added to the depreciable bases (rather than being included in the basis of land).
(2) Granting tax credits and accelerated depreciation to certified purchasers from the original builder.
(3) Preventing businesses from taking the tax advantages, then turning the property over quickly (required holding period ten years except for sale to Tenants' Council).
(4) Revising Subchapter S "to induce groups of individuals and corporations to pool their resources for the investments in housing." Subchapter S permits taxpayers to obtain the limited liability and other private legal advantages of a corporation while reporting income and loss on individual tax returns. Owners electing this treatment would be able to achieve all the legal benefits of the corporate form while enjoying tax benefits similar to those enjoyed by partners in partnership agreements.

The Kennedy bill sought to enlist the equity of the large corporations for the purpose of developing housing in urban poverty areas. It was a bill drafted in the period of the ghetto riots and very low housing production. As Joel Barlow of Covington and Burling pointed out,

> The tax aspects of the bills are extremely complex principally because so many different tax incentives are offered. It should be possible to provide the same overall tax benefits and incentives with fewer different provisions.

Kennedy himself felt there was nothing sacrosanct about the tax formula or the tax benefits of S.2100. What was required was a program to win the corporate commitment. When S. 2100 was being discussed in the Congress, there was a major disagreement between the Treasury Department and some of the tax experts who appeared in support of the bill over the actual costs of the program as compared to the rent supplement or 221 (d)(3) BMIR program. The Treasury argued that the program was more expensive on a strict analysis of dollar outflows. Those who supported the bill argued that the S.2100 program could not be compared with any existing program by virtue of its location, and that capital which went into these areas would not otherwise be devoted to housing. Therefore, in costing out the programs, there should be an allowance for the multiplier effect on an investment in housing which otherwise would not have been made. The multiplier effect in turn would return tax revenues both to local bodies and the federal

The National Corporation for Housing Partnerships

In the struggle over the outline of the 1968 Housing and Urban Development Act, the Kennedy proposals were juxtaposed to the creation of the National Corporation for Housing Partnerships (NCHP)[3/] as alternative vehicles to spur corporate involvement in housing. NCHP was to serve as the conduit for corporate equity investment in low and moderate income housing. Tax losses would be passed through to corporations through the limited partnership -- the National Housing Partnership. The argument was that corporations did not have executives skilled in the investment in housing.

Thus, rather than many corporations attempting to form their own housing divisions, a single entity was created. In point of fact, many corporations viewed their investment in NHP less in terms of a profit making investment than as a charitable contribution. This was certainly the case for the investments of labor unions who had little or no use for tax shelter.

The NCHP approach focused primarily on one aspect of the federal multifamily housing programs -- equity capital. As such it provided some impetus for housing development by lending a

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3/ It was thought that the success of NCHP would foster the creation of additional like entities as provided for in the legislation.

degree of stability and liquidity to the equity market. Other groups, however, at an early stage noted the profit potential in the syndication of FHA multifamily projects, and by 1972 there was lively competition for these projects, and the equity interest was bid up accordingly.

The Existing System and the Impact of Tax Laws

For the groups sponsoring federally assisted housing, the current tax laws have an important impact on the legal framework for sponsorship. The tax laws make it necessary to create a limited partnership in order to pass through the tax losses generated during construction and upon completion to limited partners in order for the developer and/or builder to receive his compensation. In rare instances, a builder will build for his own account. Currently, investment in low and moderate income housing is advisable only for an individual who can offset tax losses against other income taxable at a marginal Federal, state and city rate of 50% or higher. For the most part, this effectively limits investment to individuals with taxable incomes of $50,000 a year. Taking into account typical personal deductions and exemptions, this would mean a minimum adjusted gross income on the order of $65,000.

The general partner in this arrangement holds as small a share in the profits and losses of the partnership as the IRS allows without disqualifying the partnership (usually 1-5%).

The limited partners hold the remaining partnership interests secure from liability, and happy to be as distant as possible from the operation of the project.

While there is no limit on the liability of the general partner, it is important to note that the mortgage is nonrecourse, ie., the general partner is not responsible for the mortgage in a default.

A second critical impact of the tax laws is that the bulk of the losses, and hence the after tax profits are derived in the early years of a project's operation. The benefits of ownership are exhausted by the 20th year, although the mortgages run for 40 years. The return for the individual investor is based almost entirely on accelerated depreciation which creates tax losses for the project owners. (The favorable recapture provisions for federally assisted housing were added in the Tax Reform Act of 1969.) These losses could then be used by the limited partners to offset taxable income derived from other sources. For Section 236 projects the maximum 6% cash flow on stated equity was of minor importance since it was usually eaten up by operating costs or taxes, which either were underestimated at the outset or increased faster than FHA would permit rent increases.

Since very few current partnerships establish sinking funds to meet the tax liability due on project sale or default, the partnerships will prefer to pay enough for the project to limp along rather than pay even the capital gains rate on the difference between the sale price and the depreciated basis of the property. This is a different situation than the situation postulated in the projections on return, i.e., a sale of the project at the end of some designated period of time. In any event, residuals will enter into a partner's calculations only in the best of projects.

Alternative Incentives - The Tax Credit

Questions about the impact of current tax laws on the ownership structure and commitment to low and moderate income housing for the period of the mortgage have led to an examination of possible alternatives. The following analysis will focus primarily on the incentive side rather than on potential penalties under the current system (i.e., tougher penalties for default, more restrictive recapture provisions, etc.)

Tax credits have been suggested as an alternative to accelerated depreciation, which creates losses which in turn can be used to shelter other income, as a cleaner method of rewarding equity investment. Tax credits have several major advantages for corporations over the existing system. The principal advantage

lies in the accounting convention of earnings per share as a measure of corporate performance. Over the last few years, the price of stock has been calculated to reflect its relation to earnings per share, as opposed to book value in earlier days. The factor which converts earnings per share into stock price is called the multiple. The multiple is ordinarily related to growth in earning per share, i.e., the more growth the higher the multiple. Because of this convention of calculating stock price, there has been tremendous emphasis by management and stockholders alike on earnings per share. The NCHP experience is an exceptions but one can argue that the financial commitments on the part of corporations were small enough not to effect earnings per share.

The difficulty with this is that the return from investments in FHA multifamily projects, particularly Section 236, is largely derived from tax losses. The tax losses which are used to offset other taxable income have the perverse effect of lowering earnings per share. Consequently, corporate executives generally frown on such an investment. While some sophisticated analysts are beginning to look at cash flow per share -- adding back in non-cash expenses such as depreciation -- earnings per share continues to be the dominant convention. While tax losses from investments in housing doubtless would not be of the magnitude to have an adverse impact on the earning of General Motors, it is a very real consideration in the case of smaller companies,

A second difficulty with tax losses generated under the current system is that financial intermediaries such as commercial banks have special tax privileges which reduce their tax rate well below the normal 54-56% level of combined federal, and state corporate taxation. Their interest in tax shelter investments is consequently less than is that of nonfinancial corporations. A final obstacle is that for financial accounting purposes, a corporation must reserve its tax savings against future tax deficits that will arise from the project after approximately 20 years of operations (in addition to reducing its earnings per share).

For these reasons tax credits would be a far more attractive mechanism to attract corporations into holding equity in federally assisted housing. The use of credits would not, of themselves, however, change the incentives for either development or production. The credit would be calculated to give the corporate investor an immediate tax savings equal to the present value (using a discount rate of 12% for example to represent an acceptable rate of return) of the excess of

(a) the potential future tax savings it would realize from depreciation deductions, less

(b) the tax due on a hypothetical sale for 20 years.

For a tax credit mechanism effectively to attract corporate investment, there must also be provision in the Federal statute mandating a change in the financial accounting rules in regard to corporate participation. The Federal statute would provide that for financial accounting purposes:

(a) the tax credit would be treated as a "permanent reduction" of tax which increases the corporation's reported net income after tax in the year of the credit; and

(b) the corporation can report the results in regard to its interest under the cost method of accounting rather than the equity method of accounting. This, in effect, means that the corporation need not reduce its reported income by its share of the losses of the project, to the extent that said losses arise from depreciation deductions.

What could happen by using tax credits to induce corporate investment and ownership would be to make the entire process more responsible. Because of their public identities, corporations would hopefully feel a responsibility to supervise the process -- i.e., see that each specialist developer, mortgage, architect, lawyer, builder, and manager perform his job well. Tax credits, while not the only vehicle which could accomplish this responsible ownership, would be preferable to the current accelerated depreciation mechanism.

The use of tax credits rather than accelerated depreciation would also have an ameliorating effect on individual participation in federally assisted housing. Under the current system, equity is most valuable to those individuals in the highest income bracket. A simplified example points this up.

Tax Rate[1]	25%	50%	70%
Income	$20,000	$60,000	$150,000
Tax Losses	10,000	10,000	10,000
Adjusted Income	10,000	50,000	140,000
Taxes Due	2,500	25,000	98,000
Tax Liability without losses	5,000	30,000	105,000
Gain from investment (reduction in tax liability)	$ 2,500	$5,000	$7,000

[1] Tax rate is the marginal rate; thus, taxes are overstated for simplification.

Thus, under the current system a low tax bracket investor cannot compete effectively with a high bracket investor for the investment, unless he is willing to accept a lower return. Even if corporations wanted to buy equity, they could not bid effectively against a 70% tax bracket individual. While some sponsors are prosperous enough to make full use of the tax shelter, most are not. Sponsors are forced to sell out to individuals who want passive investment limited partner interests. Lower income individuals, who could use tax credits as easily as high income individuals and might reside or do business in the community, cannot afford to bid for an ownership interest. As the following example shows, tax credits are of equal value to anyone with taxable income.

Tax Rate	25%	50%	75%
Income	$20,000	$60,000	$150,000
Tax Liability without credit	5,000	30,000	105,000
Credit	5,000	5,000	5,000
Taxes Due	0	25,000	100,000
Gain from investment	$ 5,000	$ 5,000	$ 5,000

The tax credit would also cost the federal government less if it were targeted to be the equivalent of the return generated by a 40% tax bracket. (The average taxes foregone by the Treasury under the current system are based on an average bracket of 50%+.) The advantage of the tax credit for individuals and corporations is that it opens up the competition for equity interests -- because anyone with taxes due can use tax credits. A further advantage is that tax credits are simple, and avert the complexities of different types of depreciation, component depreciation and recapture rules.

In summary, tax credits are a feasible alternative to accelerated depreciation, and in fact preferable for the following reasons:

(1) Tax credits do not have adverse impact on corporate earnings per share.
(2) Tax credits would offer the same incentive to any taxpayer regardless of bracket.
(3) Tax credits are simple and easy to understand (and the corporation and the individual and the Treasury know what they are getting.)

There could also be a tax credit tied to effective management and maintenance. After designated periods of time, every fifth year for instance, there could be a tax credit based on

an appraisal of the condition of the building. It has been suggested that this same type of incentive for good management and maintenance paid out of a management escrow which is included in the mortgage, or paid out of the mortgage insurance premium. This approach is separate from the incentives of ownership provided by a tax credit, but of no less importance.

Tax credits should not, however, be viewed as a panacea. The issues involved in attracting corporations into the development and production phases have been touched on in the discussion of NCHP and the Kennedy proposal. The assumption in both was that, if you could interest corporations in the ownership phase, these corporations would ipso facto involve themselves in the development and production phases, making the delivery of housing a unitary process. What has in fact happened is that the process is fractionated into three distinct areas -- development, production, and ownership; and major corporations of the type which formed NCHP or which Senator Kennedy had in mind have not participated substantially. Those corporations which entered the development end of the business -- notably Boise Cascade -- found that the development business is a business for entrepreneurs with little overhead. Those corporations which were attracted to the construction side of the business through the Breakthrough program found that it was not easy to compete on price with conventional, stick-built construction.

While the profits from development can be substantial for an individual, they are reduced quickly by a typical corporate operation. Then, too, the entrepreneur makes sure his risk is minimal when he negotiates low options and makes "on the come" agreements with architects and lawyers. Thus, in the event his project does not materialize he is not too much out of pocket. A corporation with a public identity has trouble making such deals, and consequently its exposure is usually high. Most corporations have gone through this analysis, and view the development business as too risky and are unwilling to commit the management skills necessary to be in the business -- even if development skills could be obtained. The outlook for corporate participation is thus mixed even if a tax credit system provided new incentives for ownership and management.

Subchapter S Corporations

Under current tax law, a Subchapter S Corporation is less advantageous than a partnership for the following reasons.

(1) A shareholder in an S Corporation may claim a share of corporate losses only up to the amount of his capital contribution and his loans to the corporation. In effect, the mortgage on the project is excluded from the investor's depreciable base. In a partnership, depreciable base includes capital contribution and the project mortgage.

(2) The rental receipts would disqualify its Subchapter S status if, in any taxable year, rents (together with certain passive receipts like dividends and interest) amounted to over 20% of its gross income. In a limited partnership agreement, there is no such restriction.

(3) A Subchapter S corporation may have no more than 10 shareholders. A partnership has no such restriction.

These conditions for Subchapter S status could be remedied by making the following changes:

(1) The HUD insured loan would be permitted to be included in the investor's tax basis for his shares in the corporation.

(2) Rental receipts from a qualified project would no longer be included in passive income of the corporation.

(3) A Subchapter S corporation receiving a specified percentage of its gross receipts from the rentals of a low and moderate income houisng project and having a specified percentage of its assets invested in a project would be permitted to have up to 25 shareholders.

These changes would eliminate the risk faced by the general partner in the partnership format. The Subchapter S corporation would not be liable beyond the contributed capital. The changes also would eliminate the need for the general partner in a partnership to have substantial other assets apart from its partnership interest. Currently, the Internal Revenue Service requires that:

--the general partner of a housing partnership have a net worth (apart from its partnership interest) equal to 10% to 15% of the capital of the partnership to be recognized for Federal income tax purposes. This "other assets" requirement has been a substantial barrier to persons seeking to enter the development business. Moreover, the necessity of furnishing these other assets and leaving them at risk of the project requires packagers to charge higher fees than might otherwise be required.

These changes in the Subchapter S rules are in accord with the general purposes of Subchapter S. The 20% limitation was placed on rental and certain other receipts in the belief that they constituted "passive" income and that a corporation which receives a substantial portion of its earnings from rents, dividends, or interest should not be eligible for an incentive designed to encourage active businesses. The passive risk rationale clearly does not apply to the ownership and operation of a low and moderate income housing project which is an extremely active business.

Varying Asset Ratios for Financial Intermediaries

Another suggested method of encouraging corporate involvement in federally assisted housing is for the Federal Reserve Bank to set special reserve ratios for banks and for the Federal Home Loan Board to set special liquidity formulas for savings and loans. This is the stick, rather than the carrot approach. This argument has more frequently been addressed to the conventional loans and portfolios. Advocates of this approach would require a certain percentage of the assets of a financial institution be invested in poverty areas. This could be done by setting more generous ratios for assets invested in federally assisted housing than for other assets.

There are several problems with this approach. The first is that mortgage money has not been the problem in federally assisted housing. Federal insurance together with the Tandem Plan has provided the requisite mortgage funds. There is consequently no present need to force banks and savings and loans into mortgage commitments. This, of course, would also be true if direct federal financing were used. Additionally, individual banks and savings and loans would probably be a less efficient mechanism than FNMA for holding permanent commitments on federally assisted housing because they would not have the volume.

A further problem is that financial institutions cherish their private character, and already feel they are overregulated. The Hunt Commission dealing with the structure of United States financial intermediaries explicitly rejected this approach. The Commission argued that such forced investment would cause dislocations and inefficiencies in the capital markets, and felt the objectives could better be accomplished by direct federal action. Thus, there is overwhelming resistance to this approach in the financial institutions themselves. In this environment, it would be very difficult to set reserve ratios or liquidity formulas in such a way that financial institutions would participate of their own free will. It should be emphasized, however, that financial institutions in their corporate character could benefit from equity ownership under the advantages of the tax credit approach. In fact, many banks participate in the process already as mortgagees

and one which could be built upon by using the tax credit approach. While manipulating reserve ratios appears infeasible, the use of tax credits together with Subchapter S revisions offer the prospect of encouraging corporate investment in low and moderate income housing.

Despite the Kennedy proposals for both housing and economic development, tax credits have never been tried. (In the Kennedy bills credits would serve as a supplement to depreciation, not a replacement for it.) Corporations have never been interested enough in making substantial investments in federally assisted housing or job creating industry because of the risk/return relationship. Most corporations set "hurdle rates" for capital investment which are pegged at the corporate cost of capital (equity + debt). Hurdle rates are usually on the order of 12-15%. For an investment to be attractive, it must offer a return higher than the hurdle rate and high enough to compensate for any additional risk over competing investments. A corporation must then analyze what it will take in terms of corporate management skills and time. To date, few corporations have found the profit potential exciting enough. Tax credits offer one potential mechanism to create the interest in ownership. Hopefully, that interest would filter back in both housing and economic development to make each a unitary process which would take full advantage of corporate managerial skills and resources.

Appendix D

Tax Incentives for Housing

ABSTRACT: This paper discusses considerations of existing income tax incentives relating to housing. It recommends a direct subsidy and also provides for a tax credit as a fall-back position.

Discussion Draft No. 2 Date 6/22/73

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TAX INCENTIVES FOR HOUSING

Stanley S. Surrey

This memorandum discusses considerations applicable to a review of existing income tax incentives relating to housing. "Housing" covers rental housing with a direct HUD subsidy, unsubsidized rental housing, and owner-occupied homes (largely unsubsidized). All of these forms of housing presently obtain special benefits under the income tax, though the benefits differ in their characteristics and tax impact.[1]

I. Subsidized Rental Housing

A. Present Situation. Low-income rental housing has been directly subsidized by HUD, though at present future projects are in abeyance. Essentially the subsidy pays to the developer the difference between the cost of amortizing the actual loan and the cost of amortizing a loan at a 1% interest rate, plus a guarantee to the lender. This subsidization of part of the cost of the housing permits the rents to be held below an actual cost level. There may also be an additional direct rent supplement subsidy payment. The HUD subsidy presumably indicates that totally unsubsidized rental housing would be priced at a rent structure beyond that which many low and moderate income tenants could afford. The amount of the HUD subsidy is significant, and essential to the construction of the housing. The existence of such a direct budget subsidy presumably reflects a policy decision that supplying such housing involves an important national priority.

This being so, the first question to ask, as respects tax incentives for such housing, is why are there any tax incentives

presently provided to such housing. The answer is clear -- the amount and character of the direct subsidy and the accompanying 6% return limitation placed on the owner make it impossible for the direct subsidy by itself to do the job of getting the housing built. Hence, some additional inducement is needed. This inducement is found in present income tax benefits, e.g., mainly deduction of construction period interest and taxes and rapid tax writeoff of full construction cost (accelerated depreciation or five-year rehabilitation amortization) coupled with the cost being almost fully leveraged. But clearly the tax benefits themselves are likewise not enough alone to do the job of getting such low and moderate income housing built at an appropriate rent structure. Hence the duality of direct subsidy and tax benefits is presently needed.

But this duality of benefits only describes the present pattern -- it does not justify it. Since the direct HUD subsidy is by far the larger of the two inputs and hence cannot really be supplanted by tax benefits, the question is whether an enlarged direct subsidy could supplant the tax benefits. This question should be asked for several reasons. The tax benefits were essentially unplanned and just "grew up." As would be expected of such an accidental process, they are inefficient and wasteful. Essentially, the developer obtains his needed profit (above the construction costs covered by the loan and the HUD input by "selling" these tax benefits to passive investors. This process of selling the tax benefits is the so-called "tax shelter syndication." The developer must sell the benefits because he has insufficient income, from the housing and other activities, to utilize the benefits. But this process requires keeping the value

of the tax benefits large enough to cover a substantial profit to the investor-buyers of the tax benefits, a substantial profit to the merchandisers in the process (investment advisors, syndicators, lawyers, accountants) and, finally, the required residual profit for the developer.[2] The process is well understood by those familiar with the housing area, and further description here is thus not necessary. The essential point is that, under this roundabout method of compensating the developer, a considerable part -- perhaps 30% or more -- of the revenue cost to the Treasury of the tax benefits is diverted to those in the chain. The investors get their "commission," the syndicators get their "commission," the lawyers and accountants get their "commission," all as part of the process of ultimately turning the Treasury revenue loss from the tax benefits into dollars in the developer's hands.

Clearly, if the developer could obtain his required profit directly from HUD, then the wastage now occurring through the Government's also paying (through the tax system) profits to investors and syndication merchandisers would be eliminated. The mechanics of the dual tax benefits and subsidy system indicate there is no other essential role to be played by the investors, since HUD through its control over the direct subsidy controls the basic decisional factors of location, amount of housing, etc.[3] Any conceivable advantages of private sector participation are therefore really lacking in view of the essential importance of the basic HUD subsidy. HUD should therefore complete the task of directly supplying the needed inducements to the developer.

There is another inherent defect in the present roundabout system of compensating the developer, and that is the "tax shelter" aspect of the process. The tax benefits now "sold" to the inves-

ors through syndication of the HUD subsidized housing provide tax deductions far in excess of the rental income from the housing. Hence, the investor, to make tax use of the tax benefits he has purchased, must offset the excess deductions against his non-housing income, such as dividends, professional income, executive salary and the like. But this is a game to be played only by those in high income tax brackets, 50% or above, year-in, year-out. Hence, it is a game only for the really well-to-do in our society, or large corporations. But the game for them is clearly worthwhile, for it can eliminate almost all income tax liability for these individuals if properly played.[4] However, Congress and the public are beginning to understand this "tax shelter" game and the tax escapes which it provides. They are also commencing to see the essential immorality of the "tax helter" process -- the making of tax millionaires under the claim of providing housing for low income groups -- and are asking why a better way cannot be found to meet our housing problems. As a result, the present method of using tax benefits and the "tax shelter" process to compensate the developer of subsidized housing is fast becoming too unstable -- as a tax matter -- to survive.[5]

The Treasury has now recognized this weakness in the present system and has recently made proposals for change.[6] As respects rental housing, these proposals (under the Limitation on Artificial Accounting Losses -- LAL) would allow the deductions created by accelerated depreciation on new rental housing in excess of straight-line depreciation, by the five-year amortization in excess of straight-line depreciation on rehabilitated housing, and by the deductions (such as interest and real estate taxes) llowed during the construction period, all to be used only

against income from residential property held for rental or sale.[7] Essentially, this proposal would eliminate the passive investor who now buys in to one or two subsidized housing tax shelters,[8] since he could not use the "tax losses" created by these deductions -- the typical housing tax shelter "losses" -- to offset his non-housing income. Since such an offset is under present law the whole point of this tax shelter game, the game would be over. A wealthy individual with a large portfolio of residential real estate investments might perhaps find the game worthwhile, since all of his real residential real estate is regarded under the proposal as a single investment, and deductions on one item of residential real estate can be used against income from another item. (This is a defect of the proposal. This result is not allowed for commercial real estate under the proposal, where it is applied essentially building by building.) Also, the proposal does not apply to corporations. This last aspect is a defect of the proposal, for it is difficult to understand why corporations should still be permitted to play the tax shelter game to escape or reduce tax. And it is also hard to see why wealthy individuals with a large real estate portfolio should still be benefitted. Moreover, they could benefit only if they had tax loss housing to parley with tax profit housing. While gimmicky tax shelter packages might be arranged to promote these situations, such developments are not a healthy situation. But under this proposal, unless banks or other corporations are to take over all investment in HUD subsidized rental housing, it would appear that the ability of present tax benefits to compensate the developer is ended. The present passive investors in such housing would drop out, the syndications would end, and the developer would no longer secure his profit through the sale of the

new method of compensating the developer of subsidized rental housing.[10] Since HUD is already engaged in directly subsidizing that housing and since the present direct subsidy is considerably larger than the tax subsidy to be replaced, the sensible course would be for HUD to directly provide the needed profit through a subsidy to the developer.

It should not be difficult for HUD to devise a direct subsidy to the developer to replace the residual funds he now obtains through selling tax benefits via tax shelter syndication. In that syndication process the developer now receives an amount equal to about 15% of the mortgage. Out of this he must pay about one-fifth (three percentage points) to those handling the syndication. The balance, about 12% of the mortgage (about 11% of the development costs) covers any cash outlay he must make and his profit. Hence, HUD should seek a method to pay this 12% directly to the developer, and thus short-cut the present roundabout method. For example, the Builder Sponsor Profit and Risk Allowance could be increased say to 22% or so. Perhaps the increase could be paid in annual installments over a period of years to encourage adequate management.[11] The present tax benefits for subsidized housing -- accelerated depreciation, five-year amortization for rehabilitation, deduction of construction period interest and taxes, and inadequate recapture of excess depreciation on sale -- would disappear. The government would gain through the substitution of direct subsidy for present tax benefits, since it would no longer be paying a "Commission" to the investors and to the merchandisers of the tax shelters. Hence the amount to be paid directly to the developer would of necessity be less than the present revenue loss from the tax benefits for subsidized housing. The technique suggested above is one possibility. Housing experts may suggest others.

But the point is that experts concentrating on a direct subsidy for the developer ought to be able to find one.

C. A Different Tax Subsidy. It may be said -- arbitrarily I think -- that a direct subsidy is not acceptable, perhaps because it would show up as a budget item, whereas the present tax benefits are hidden, as are all such tax expenditures, in the total revenue figures.[12] If so, we must still look to the tax system to provide the developer with a profit. The task then, unappealing though it may be, is to see if a better set of tax benefits can be found. Put differently, how would we structure a tax incentive system for subsidized housing that is aimed deliberately at supplementing the HUD direct subsidy to replace the present ccidental" tax benefit system.

Professor Taubman in his report has made several suggestions of new tax benefits to replace the present tax subsidy structure. Largely, those suggestions seem aimed at non-subsidized housing. Thus, the suggestion of tax credits to mortgage lenders is not really relevant to subsidized housing where a direct subsidy already produces a 1% interest rate; tax credits to tenants for excess rents are not needed when a rent supplement program exists. These suggestions will therefore be considered later in the context of non-subsidized housing. As for subsidized housing, his suggestion of a tax credit on rental housing to replace accelerated depreciation generally can, however, be considered. Such a credit presumably a percentage of the cost, is really the direct subsidy urged above but dressed up in tax clothing. Speaking generally, f we wish to pay a developer $X, then we can give him a direct bsidy equal to $X or a credit against tax equal to $X.[13]

There are certainly advantages to such a tax credit as against the present system. The credit would be separable from

the basic income tax structure and not mixed up with (i.e. hidden in) the deductions for depreciation, interest, taxes, etc., all of which when properly used have a legitimate tax role apart from any incentive load they are today asked to bear. The credit can be varied to suit the needs of the market and government policy as those needs are perceived. But there are problems with a tax credit. $X provided through a direct subsidy is different from $X provided through a tax credit, and the problems lie in the difference.

Credits against income tax are useful to the recipient of the credit only if an income tax exists of sufficient size to absorb the credit. If not, the credit is wasted and is no incentive. Hence, non-profit tax-exempt developers (religious groups, colleges, pension plans, community groups, state and local organizations, etc.) cannot receive any incentive through the credit, though they could utilize a direct subsidy. Private developers with losses elsewhere or otherwise insufficient tax liabilities are also ruled out by the credit approach compared with a direct subsidy. Indeed, developers today sell their tax benefits precisely because they do not have sufficient income against which to utilize those benefits. A credit against tax would presumably leave such developers in the same position. Hence, to make use of the credit they would have to pass it through -- sell it -- to investors and we would have tax shelter syndication all over again. If -- as essentially is true under the recent Treasury LAL proposal -- the developer would not be permitted to do so, then essentially all development of subsidized housing would either be turned over to corporations and a few wealthy individual developers, or if they do not step in, the production of such housing would cease.

These difficulties with the credit could be overcome by making the credit <u>refundable</u>, i.e., payable directly by the Treasury in those cases where the developer's tax liability was not large enough to absorb the credit or it was a tax-exempt developer.

At this point, the tax credit is really a direct subsidy of $X paid through the tax system. But there would still be a difference. The tax credit would reduce a developer's income tax, and might, depending on its size, eliminate that tax entirely. This comes back to the unappealing aspect of having to devise a tax incentive. We must remember there is an inherent tension involved in using a tax incentive to accomplish a national priority such as adequate rental housing. The tax incentive must be large enough to induce the private participation. But any such incentive will ipso facto materially reduce the tax paid by the person involved in relation to his actual economic income. Hence, the transaction will remain an inviting target for tax reformers. They will point to the escape from tax of the individuals involved - and such a situation is the best climate to urge tax reform. et the escape from tax is inherent in the reliance on the tax incentive -- it is what such tax incentives are all about. Society may have to pay large profits to induce people to undertake otherwise risky tasks -- but at least those profits are subject to our income tax system. Tax incentives undercut the entire equitable foundation of that system, and hence their inherent tension.

This tension inherent in the tax credit could be resolved by including the credit in income, and adjusting the amount of the credit to keep its incentive effect at the necessary level.[14] At this point we certainly have the full equivalent of a direct subsidy, which would also be includible in income. The choice between the two then shifts to other factors. Thus, for example, it would be desirable to have the Congressional Committees directly concerned with housing, e.g., House Banking and Currency, have jurisdiction over a subsidy to developers so as to coordinate it with the other HUD housing subsidies rather than to split urisdiction over housing subsidies between those committees and ne Tax committees. Equally, HUD and not the Internal Revenue Service should administer the subsidy system. The subsidy should appear in the Budget.

All this points to a direct subsidy rather than the tax credit. If, however, a tax route is desired, then a tax credit of a refundable character available to the developer, and itself includible in income, seems the choice for initial exploration.

II. Non-Subsidized Rental Housing

A. Present Situation. Prima facie it can be said that since middle income and luxury rental housing presently do not receive a direct budgetary subsidy, such housing simply does not have a national priority requiring governmental financial assistance. Hence, it should not receive any tax incentives and the present tax preferences should be eliminated. Indeed, one suspects that f low-income HUD subsidized rental housing ceased to receive tax enefits (because the direct subsidies were enlarged) the Congress would look more skeptically at the tax incentives for the remaining rental housing. But perhaps it is possible to argue -- though I doubt the historical foundation for the argument -- that a direct subsidy is not here granted because Budget directors, HUD and Congress, while believing some governmental assistance is needed, have left the furnishing of that assistance to the tax system. If so, that decision has here also meant inefficiency and wastage, for the reasons earlier indicated and additional reasons.

A good deal of tax assistance to non-HUD subsidized rental housing operates through the same tax shelter syndication process as in the case of subsidized housing. This is because the developers of non-subsidized housing, as in the case of subsidized housing, often do not have enough income of their own to absorb the tax benefit deductions accorded to rental housing. Their mortgages are pushed to as high a level as the proposed rent :ructure on the housing will permit. The consequent deductible .nterest component of the mortgage debt plus accelerated depreciation and other tax benefits total an amount larger than the rents, and "tax losses" result. Moreover, since the rents are needed to

carry debt service and expenses, the developer must look to syndication of those tax losses for his profit. Hence here also we have the waste and inefficiency of the roundabout method of compensating the developer. We also have the tax escape immorality of the tax shelter process.

But there is a crucial difference in the function of present tax benefits between subsidized and unsubsidized housing. Without the tax benefits, roundabout and wasteful though their assistance to the developer may be, the subsidized housing would not be built. The HUD 6% limit on the return to the developer is obviously inadequate. Since rents cannot be increased, the developer has nowhere else to turn for his profit except to sell the tax benefits. (This present sine qua non aspect of tax benefits for subsidized housing is of course, as we have seen, no vidence of any inherent virtue in tax incentives, but rather a result of the HUD direct subsidy system and the national priority of setting rental ceilings for this housing.) But when we turn to non-HUD subsidized housing, the picture is completely different. Here the government may be getting little or nothing in return from the financial assistance given through the tax benefits, be the assistance in any particular case roundabout via the tax shelter process or through direct use of the tax benefits by the developer. Indeed, the net result of such financial tax assistance may be harmful to the housing field.

Professor Taubman's paper contains the following conclusions as to the effectiveness and consequences of the present tax benefits, which conclusions appear to be directed to non-HUD subsidized housing:[15]

> To summarize this material, it seems likely that the tax subsidy being discussed has increased the quantity of buildings and especially expensive buildings. It may also have increased the surface luxuriousness of buildings. But partly because of market adjustments to subsidies and partly because of the incentives to rapid turnover and thus to shoddiness, the useful life and true quality are probably reduced. . . .

> Because the subsidies are paid on all housing including those that would have been built anyway and because the supply response to price changes is limited, these subsidies are very expensive. A hypothetical example will best illustrate this. Suppose that without the subsidies there would be 1000 houses costing $100 each. Next, suppose that tax subsidies of 5% are introduced and that this increases the supply of housing 10% to 1100 units. For simplicity assume that the construction cost remains at $100. The total cost of the subsidy is $5500 ($5 times 1100 units). Thus, the average effective subsidy cost for each of the 100 new houses produced by the subsidy is $55 or 55% of the construction cost of houses. Thus, this tax subsidy which is paid on all housing will rate low on the cost effectiveness criteria (unless the price elasticity of demand is huge). . . .
>
> The above evaluation would indicate that most of the tax subsidies to housing are expensive given the extra housing they produce, that they provide a tax shelter for upper-income persons, and that they tend to discriminate against proper maintenance and repair practices and lead to an artificial shortening of the useful life of a building. In addition, while in principle, most of the subsidies apply to all housing, in practice moderately or very expensive housing has been produced by the tax subsidies. For several reasons, these changes may not filter down to the poor as increased quality or lower rents.

Given these effects of the present tax benefits, the initial question is simply why not eliminate those benefits and let the marketplace govern rental housing for middle and upper income groups. There would be no HUD subsidy, as there is none today, and no tax benefits.

Most of the trade associations in the housing field have expressed institutional dismay over such a proposed elimination of tax benefits for rental housing. They have voiced to the House Ways and Means Committee the customary pessimism about the future that immediately descends on any industry faced with the loss of its tax benefits.[16] Most of these Associations indicated that the basic result of a loss of tax benefits would be a rise in

rents. But this contention by no means is as conclusive against such a change as the Associations seem to consider. First, it is not at all clear that rents in non-subsidized housing would rise, or rise by much. One builder, in taking a contrary view and directly attacking the present tax benefits, stated that many builders today do not even use accelerated depreciation for tax purposes (presumably because straight-line depreciation itself provides a sufficient buffer against tax liability and they do not desire to syndicate their buildings), and hence its elimination should not affect rents.[17] Professor Taubman elsewhere has indicated that any rise in rents if tax benefits were removed would be quite limited.[18] Second, if rents for such housing did rise somewhat, why should this be a national concern requiring government action. Certainly we do not have a national priority to support a low rent structure for luxury or semi-luxury housing. If HUD became concerned about rent increases at the lower end of the present non-subsidized housing scale, it should turn to providing a direct subsidy to meet that concern.

At any event, the burden of proof both for retaining governmental financial assistance for non-HUD subsidized rental housing and for providing that assistance through tax benefits must be placed on those who urge continuance of the present tax benefits. Moreover, given the strong case against the present system, any proof made for its continuance must be solid indeed and not just unsupported pessimism.

B. A Direct Subsidy. As indicated above, perhaps the wisest course as to non-subsidized rental housing would be to remove the present tax benefits, and then see what happens to housing starts and rents -- and also see if the events have any relation to the tax changes. If rents begin to rise in the income area where such a rise may present a national concern, then HUD should be ready with a direct subsidy to meet the problem. Thus, if HUD is concerned about rent increases (or lessened housing starts because of rent problems) in, say, units now renting under $200 a month, one

possibility is a direct grant to the builder for such units, so that the rents are kept at proper limits. Another possibility is an interest subsidy on the financing for such units. Professor Taubman's paper points out that "a reduction in mortgage rates can be quite an effective tool," and can thus compensate for any detrimental effect from the elimination of tax benefits.[19] There undoubtedly are other possibilities, all of which would be less costly to the government than the present tax benefits.[20] The point here, as in the case of present HUD subsidized housing, is that HUD experts should be able to devise any needed direct subsidies, if the need becomes evident and the focus is held on providing a direct subsidy.

C. A Different Tax Subsidy. Here also, however, it may be ordained that, if financial assistance were shown to be needed for non-subsidized housing once present tax benefits were removed, the assistance should still be given through the tax system, albeit with a different type of tax subsidy, than through a direct subsidy. If so, the search must be for a new tax subsidy. Professor Taubman's paper suggests a number of alternatives. One of these alternatives, a tax credit to the developer (owner) has already been discussed. One problem is to prevent such a credit from becoming another tax shelter. Any such credit should be aimed as far as possible at the marginal developer who, supposedly, needs governmental financial assistance to undertake the development. But if he cannot use the credit because of his tax posture and thus cannot obtain the financial assistance offered by the tax subsidy, he can do better by selling the tax subsidy to a passive investor who then takes his handsome "commission" on the purchase -- and we still have a tax shelter.[21] If this consequence is blocked by making the credit refundable, as earlier suggested, then the benefits of the credit would be confined to the real estate industry. But here we then face the other dilemma. Tax subsidies, such as credits, to be successful incentives must offer significant tax reductions. Hence, if the credit is significant,

it automatically has the effect of allowing the real estate industry to escape a considerable part of its tax burden. In turn, the industry becomes a target for tax reform, and the situation is thus unstable because of this tension between desired effective subsidy and the tax escape consequence -- an inevitable tension if tax subsidies are used.[22] A refundable credit itself includible in income is the best approach -- which of course is a direct subsidy in tax disguise.[23]

Professor Taubman also suggests the possibility of moving through the mortgage lenders rather than the developers or owners and here offers tax credits to the lenders of mortgage money. This of course is a tax alternative to a direct subsidy to lenders designed to lower mortgage rates. Here also one would have to consider the problems that may arise if the credit is non-refundable, and the degree of tax escape that is inherent in the credit itself. He also, again using the credit device, suggests the route of aiding the tenant (rather than the owner or lender) through a credit for excess rents. He also points out the need for a refundable credit to aid the tenant whose tax liability is not high enough to absorb the credit. Finally, he suggests the possibility of a credit for repairs.

These suggestions, as Professor Taubman's paper indicates, have one thing in common. They are all untried and each has many unsolved problems of structure and content.[24] Clearly, under these circumstances it would be desirable to preserve both maximum flexibility to make needed changes and maximum coordination with direct housing programs. All this is a task in the first instance for housing experts and not tax experts. But tax subsidies lack both the flexibility and the coordination. Moreover, the tax experts take over to worry about the tax problems -- which are likely to be numerous with such untried devices -- and the housing problems become submerged or unseen. The proper course in experimenting with Professor Taubman's suggestions would therefore be to devise the direct subsidy counterparts of his

alternatives and let HUD and the Housing Committees in Congress experiment rather than have the Tax Committees and the Internal Revenue Service undertake the task. There is no reason why HUD cannot disburse subsidy checks; it is essentially a direct subsidy agency to begin with. But if tax subsidies are required, the least dangerous course would appear to consider the credit for the developer, refundable and includible in income as discussed above, or perhaps the credit for the lender, also so structured. The credit for the tenant and the credit for repairs appear to possess many novel structural problems, especially if they are designed to carry the tasks Professor Taubman, properly, seeks to assign to them in his paper.

III. Owner-Occupied Housing

Although there is some limited direct HUD budgetary aid, the present social goal of encouraging owner-occupied homes is left to the tax system. While the historical origin of the income tax deductions for mortgage interest and real estate taxes is murky, at least for some time these deductions have been defended as instruments of financial assistance to homeowners. But being originally untargeted as such, they are also wasteful and unfair. They assist not only a principal residence, but also one or more vacation homes. They assist the wealthy and the middle class -- but not those too poor to pay an income tax. Moreover, they provide the greatest assistance to those well off, since the higher the individual's tax bracket, the larger the tax assistance from the deductions.[25]

The Treasury has come to recognize the inequitable tax preferences inherent in this tax subsidy system for owner-occupied homes. In its recent tax proposals[26] it recommended a new form of minimum tax for individuals which would treat deductions for home mortgage interest and real estate taxes (along with other itemized deductions such as those for charitable contributions and other state

and local taxes and investment interest in excess of investment income) as tax preferences. These tax preferences when added to certain exclusions, principally percentage depletion and one-half of capital gains, could in effect not exceed one-half of the individual's adjusted gross income.[27] The overall structure of the proposal is such, however, that it would be expected to have little impact on taxpayers in brackets below $50,000. It would not be likely, all in all, to affect appreciably the present tax treatment of home ownership.

No direct HUD program of assistance would have (or has) the bizarre, open-ended, upside-down structure inherent in the present tax assistance to home ownership. On the assumption -- which seems proper -- that national priorities require continued governmental financial assistance to home ownership, the task should be to see f HUD can devise direct programs that are better structured, fairer, and less wasteful than the present tax subsidies. HUD already has limited direct subsidy programs in the home ownership field (in addition to FHA) aimed at reducing mortgage interest rates by subsidizing a given interest level. Perhaps these programs could be expanded.[28] Perhaps direct aid might be given for a certain amount of mortgage interest and property taxes through HUD checks sent directly to the owners. Parenthetically, it is no answer to the search for such direct programs that they might in the end involve fewer strings or qualifications compared with other direct subsidy programs. It must be remembered that the present tax subsidies to home ownership have no strings or qualifications at all. As in the case of rental housing, presumably we could be confident that HUD, if it is desired, could devise direct subsidy programs better than the present defective tax benefits to assist home ownership.

However, one doubts that the country is ready for such a arge shift from tax assistance for home ownership to direct assistance. (We could be willing in this area to accept direct assistance in <u>addition</u> to tax assistance, e.g., the present HUD

programs, since it is recognized that the present tax assistance is of limited aid to those in lower income brackets.) Nor is it likely that Congress would turn to wholly new forms of tax assistance for home ownership. Professor Taubman's recommendations in his paper on the whole appear aimed at rental housing rather than home ownership. His tax credit for lenders could perhaps apply, and of course it is a variant of HUD's present limited program of reducing interest rates for home owners.

The initial task in the case of home ownership would thus appear to be that of limiting, and thereby making fairer, the present tax assistance. Thus, the tax assistance could be restricted to the principal residence of the taxpayer and to a limited dollar amount of mortgage interest and property taxes.[29] Perhaps a larger step could be taken and the present deductions for mortgage interest and property taxes changed to credits against tax. Perhaps -- a still larger step -- such credits could be made refundable to some extent, i.e., payable directly if the individual's tax liability is insufficient to absorb the full credit.[30] This last step of course, as explained earlier, is working back toward a direct subsidy. In this context it would be moving indirectly to a system of housing allowances. Such a refundable credit[31] may be too much for the present climate -- as may even be more modest changes in the tax assistance. Perhaps the most viable approach is that first suggested, of placing ceilings on the present tax assistance. Any revenue so saved could be used for other housing programs, perhaps for expanded HUD direct programs in the home ownership area.