NMHC National Multi Housing Council®
Apartments: Smart Communities, Smarter Living

National Apartment Association

The Honorable Dave Camp
Chairman
Committee on Ways and Means
House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Sander Levin
Ranking Member
Committee on Ways and Means
House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

April 4, 2013

Dear Chairman Camp and Ranking Member Levin:

The National Multi Housing Council (NMHC) and National Apartment Association (NAA) respectfully submit this letter for the record for the House Ways and Means Committee's tax reform working group study.

NMHC/NAA represent the nation's leading firms participating in the multifamily rental housing industry. Our combined memberships engage in all aspects of the apartment industry, including ownership, development, management and finance. NMHC represents the principal officers of the apartment industry's largest and most prominent firms. NAA is a federation of 170 state and local apartment associations comprised of approximately 60,000 multifamily housing companies representing more than 6.6 million apartment homes throughout the United States and Canada.

Background on the Multifamily Housing Sector

Prior to addressing the multifamily housing industry's recommendations for tax reform, it is worthwhile to take a moment and note the fundamental role multifamily housing plays in providing safe and decent shelter to millions of Americans, as well as the sector's considerable impact on our nation's economy.

Today, there are 19.3 million apartments (properties with five or more units) in the U.S. that, taken together, provide a place to live for 35 million residents. In this decade, renters could make up half of all new households—more than seven million new renter households. Because of these changes, University of Utah Professor Arthur C. Nelson predicts that half of all new homes built between 2005 and 2030 should be rental units.

Unfortunately, supply is already falling short of meeting this demand. With forecasts indicating that there could be upwards of seven million new renter households this decade, an estimated 300,000 units a year must be built to meet expected demand; yet just 130,000 apartments were built in 2011. Furthermore, while the market continues to work through an oversupply of single-family housing, the nation could actually see a shortage of multifamily housing. The shortage is particularly acute for low- and moderate-income households. The Harvard Joint Center for Housing Studies estimates a nationwide affordable housing shortfall of three million units.

Finally, in addition to providing shelter, apartments have a tremendous impact on our nation's overall economy and job creation. In fact, the construction of 100 apartment homes alone generates over 300 jobs and nearly $11 million in direct spending arising from new construction, management of the newly built units, and resident spending. On an aggregate basis, the multifamily industry has a total national economic impact of $1.1 trillion and supports over 25 million jobs.

Key Priorities for Tax Reform

Owners, operators, and developers of multifamily housing have a considerable stake in the outcome of the debate over how to reform and simplify the nation's tax code. Industry participants pay tax at each stage of an apartment's lifecycle. Put another way, taxes are paid when properties are built, operated, sold, or transferred to heirs. The apartment industry favors pro-growth reform that does not disadvantage multifamily housing relative to other asset classes. We respectfully make the following recommendations with regard to how specific components of the tax code should operate.

Priority 1: Tax Reform Must Not Harm Pass-Through Entities.

The multifamily industry is dominated by "pass-through" entities (e.g., LLCs, partnerships and S Corporations) instead of publicly held corporations. Indeed, over three-quarters of properties are owned by pass-through entities. This means that a company's earnings are passed through to the partners, who pay taxes on their share of the earnings on their individual tax returns. This treatment contrasts with the taxation of large publicly held corporations or C corporations that often face two levels of tax. Those entities remit tax at the corporate level under the corporate tax system. Shareholders are then taxed upon the distribution of dividend income.

The multifamily industry opposes any tax reform effort that would lead to higher taxes or compliance burdens for pass-through entities. For example, given that Congress recently raised marginal tax rates on ordinary income to as high as 39.6 percent as part of the *American Taxpayer Relief Act of 2012*, rates should certainly not be increased once again. Additionally, while many are calling for a reduction in the nation's 35 percent corporate tax rate, flow-through entities should not be called upon to make up the lost revenue from this change. Nor should flow-through entities be subjected to a corporate-level tax as President Obama proposed be examined in the White House's February 2012 report, *The President's Framework for Business Tax Reform*. Finally, a corporate rate cut should not be financed by denying flow-through taxpayers credits and deductions.

Priority 2: Maintain the Current Law Tax Treatment of Carried Interest

NMHC and NAA would also like to use this opportunity to underscore our strong opposition to proposals to change the current law governing the tax treatment of carried interest. If enacted, this proposal would significantly reduce the ability to develop or rehab apartments across the nation.

A "carried interest," also called a "promote," has been a fundamental part of real estate partnerships for decades. Investing partners grant this interest to the general partners to recognize the value they bring to the venture as well as the risks they take. Such risks include responsibility for recourse debt, litigation risks and cost overruns, to name a few.

Current tax law, which treats carried interest as a capital gain, is the proper treatment of this income because carried interest represents a return on an underlying long-term capital asset, as well as risk and entrepreneurial activity. Extending ordinary income treatment to this revenue is inappropriate. Notably, any fees that a general partner receives that represent payment for operations and management activities are today properly taxed as ordinary income.

Taxing carried interest at ordinary income rates will adversely affect real estate partnerships. At a time when the nation already faces a three million unit shortage of affordable rental housing, increasing the tax rate on long-term capital gains will discourage real estate partnerships from investing in new construction. Furthermore, such a reduction will translate into fewer construction, maintenance, on-site employee and service provider jobs during a period in which the unemployment rate remains abnormally high.

For these reasons, in 2010, both the U.S. Conference of Mayors and the National Association of Counties passed resolutions opposing this proposal as it relates to real estate partnerships and urged Congress to maintain the current law-capital gains treatment of “carried interest,” noting that any change would bring extremely negative consequences to “main streets” throughout the country.

Finally, some in Congress see the tax revenue generated by the carried interest proposal as a way to offset the cost of other tax changes. Enacting a bad tax law, such as changing the taxation of carried interest, merely to gain revenue to make other tax changes, is a distorted view of tax policy, which demands that each tax proposal be judged on its individual merits.

Priority 3: Retain the Full Deductibility of Business Interest

Under current law, business interest is fully deductible. However, efforts to prevent companies from overleveraging are leading to an examination of whether the current 100 percent deduction for business interest expenses should be curtailed. Unfortunately, reducing this deductibility would greatly increase the cost of debt financing necessary for multifamily projects, curbing development activity.

As mentioned above, over three-quarters of multifamily properties are owned by pass-through entities. Because such entities often look to debt markets to garner capital, the full deductibility of interest expenses is critical to promoting investment. Indeed, according to the Federal Reserve, as of September 30, 2012, total multifamily debt outstanding was $846.6 billion. Reducing the full deductibility of interest would undoubtedly increase costs for owners and developers of multifamily housing and negatively impact aggregate construction.

In addition to harming the multifamily industry, it is also instructive to note that modifying the full deductibility of business interest would be precedent setting. In fact, Drs. Robert Carroll and Thomas Neubig of Ernst & Young LLP concluded in their analysis, *Business Tax Reform and the Tax Treatment of Debt*:

> The current income tax generally applies broad income tax principles to the taxation of interest. Interest expenses paid by borrowers are generally deductible as a business expense, while interest income received by lenders is generally includible in income and subject to tax at applicable recipient tax rates. With this treatment, interest income is generally subject to one level of tax under the graduated individual income tax rates. This is the same manner in which most other business expenses, such as wages payments to employees, are taxed, and also follows the practice in other developed nations.

Priority 4: Protect the Low-Income Housing Tax Credit and Make Permanent the Flat 9 Percent Credit

The Low-Income Housing Tax Credit (LIHTC) has a long history of successfully generating the capital needed to produce low-income housing while also enjoying broad bipartisan support in Congress. According to the National Council of State Housing Agencies, the program has led to the construction of more than 2.4 million units since its inception in 1986. Maintaining this supply of affordable housing is critical given that the market is short at least three million affordable rental units, according to Harvard University estimates. The program has also been an important source of economic development for many communities, helping to revitalize struggling neighborhoods. At its peak, the LIHTC program created approximately 140,000 jobs and $1.5 billion in state and local tax revenues annually.

The LIHTC has two components. The so-called 4 percent tax credit can be used to subsidize 30 percent of the unit costs in an acquisition of a project and can be paired with additional federal subsidies. In contrast, the 9 percent tax credit supports new construction by subsidizing 70 percent of the costs.

Developers receive an allocation of LIHTCs from state agencies through a competitive application process. They generally sell these credits to investors, who receive a dollar-for-dollar reduction in their federal tax liability paid in annual allotments, generally over 10 years. The equity raised by selling the credits reduces the cost of apartment construction, which allows the property to operate at below-market rents for qualifying families; LIHTC-financed properties must be kept affordable for at least 30 years. Property compliance is monitored by state allocating agencies, the Internal Revenue Service, investors, equity syndicators and the developers.

First and foremost, Congress should retain the LIHTC as part of any effort to overhaul the nation's tax code. It should also improve the LIHTC by making the flat 9 percent and 4 percent tax credit rates permanent. Because these rates float and are not fixed, their value can be reduced by as much as 50 basis points, which, in turn, reduces the amount of resources available to finance affordable housing.

Notably, in January 2013, Congress enacted the *American Taxpayer Relief Act of 2012* that extends the temporary fixed rate on the 9 percent tax credit for projects that received a LIHTC allocation prior to January 1, 2014. Given the current low interest rate environment, the actual value of the credit is likely to fall below the 9 percent mark for projects receiving an allocation following the deadline, reducing investors' activity in the affordable housing sector. For this reason NMHC and NAA propose to make the fixed 9 percent credit permanent and to extend the fixed rate policy to the 4 percent tax credit, keeping financing flowing for acquisitions.

Priority 5: Preserve Current Law Estate Tax

As part of the *American Taxpayer Relief Act of 2012*, Congress has enacted permanent estate tax relief legislation. The Act sensibly establishes an exemption level of $5.25 million (indexed for inflation) and a top tax rate of 40 percent. It also retains the stepped-up basis rules applicable to inherited assets. NMHC and NAA believe that the current structure of the estate tax effectively enables owners, operators and developers of multifamily housing to transfer assets to future generations. The law should not be further modified as part of tax reform.

There are three key elements to the estate tax: (1) the exemption level; (2) the estate tax rate; and (3) the basis rules. While all three elements are important for all types of estates, estates with significant amounts of depreciable real property are especially concerned with how various types of basis rules may affect them.

- *Exemption Levels:* The estate tax exemption level is, in simplified terms, the amount that a donor may leave to an heir without incurring any federal estate tax liability. In 2013, there is a $5.25 million exemption.

- *Tax Rates*: The estate tax rate applies to the value of an estate that exceeds the exemption level. The maximum rate is 40 percent.

- *Basis Rules:* The basis rules determine the tax basis of inherited property. There are generally two different types of basis rules—stepped-up basis and rollover basis. The estate tax today features stepped-up basis rules, and under this regime, the tax basis of inherited property is reset to reflect the fair market value of the property at the time of the inheritance. By contrast, under rollover basis, the tax basis of the inherited properties is the same for heirs as it was for the donor. This includes any decreases in tax basis to reflect depreciation allowances claimed by the donor in prior years. Retaining a stepped-up basis rule is critical for estates that contain significant amounts of depreciated real property as it helps heirs reduce capital gains taxes and maximize depreciation deductions.

Conclusion

In closing, NMHC/NAA look forward to working with the House Ways and Means Committee, as well as the entire Congress, to craft tax reform legislation that would promote economic growth and the nation's multifamily housing needs. In communities across the country, apartments enable people to live in an home that is right for them. Whether it is young professionals starting out, empty nesters looking to downsize and simplify, workers wanting to live near their jobs, married couples without children or families building a better life, apartment homes provide a sensible choice. We stand ready to work with Congress to ensure that the nation's tax code helps bring apartments, and the jobs and dollars they generate, to communities nationwide. Should you have any questions or wish to discuss these issues further, please contact Cindy Chetti, NMHC's Senior Vice President of Government Affairs, at 202-974-2328.

Sincerely,

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