Statement

On Behalf of the
National Association of Home Builders

Committee on Ways and Means
Tax Reform Working Group on Debt, Equity, and Capital

<u>Tax Treatment of Debt and Equity in Real Estate</u>

April 4, 2013

Introduction

Founded in 1942, NAHB is a federation of more than 800 affiliated state and local building industry associations. It is the voice of the housing industry in the United States. NAHB represents more than 140,000 builder and associate members throughout the country, including individuals and firms that construct and supply single-family homes, as well as apartment, condominium, multi-family, commercial and industrial builders, land developers and remodelers.

Access to household and business debt financing is critical for the operation of a modern economy. Debt enables individuals to finance the purchase of durable goods and to invest in long-term assets. In turn, durable goods and investments provide a stream of benefits over time, and the use of debt aligns the cost of these goods/investments with the flow of their benefits. For most households, the largest investment decision they make will involve the purchase of a home, which is both a durable good (in that it provides a flow of housing services) and an investment (in that it is a capital asset that must be maintained and can be sold for a gain or loss).

Housing's Economic Impact

Housing plays a central role in the economy. Housing contributes to gross domestic product (GDP) in two basic ways: through private residential investment and consumption spending on housing services. Historically, residential investment has averaged roughly 5 percent of GDP while housing services have averaged between 12 and 13 percent, for a combined 17 to 18 percent of GDP. These shares tend to vary over the business cycle. Residential investment includes construction of new single family and multifamily structures, residential remodeling, production of manufactured homes, and brokers' fees. Consumption spending on housing services includes gross rents (which include utilities) paid by renters, and owners' imputed rent (an estimate of how much it would cost to rent owner-occupied units), and utility payments.

Currently, because of the impacts of the Great Recession, housing's total contribution to GDP stands at 15.1 percent. While lower than historical averages, the share has been rising over the last year. Housing starts stand at a 917,000 annualized pace as of February 2013, and NAHB expects to reach the one million starts a year pace near the end of 2013. Home builders are also adding jobs, after losing more than 1.4 million positions as result of the Great Recession. In fact, over the last four months, home builders have added nearly 60,000 positions, and shortages of skilled labor are now more commonly reported.

And the industry has much room to grow. Given the growth in population and the need to replace older housing stock, the normal housing starts rate lies between 1.5 million and 1.8 million starts a year. Until the nation's housing markets fully recover, there can be no robust economic recovery for the economy at large. Housing is linked to household wealth, consumer confidence, a healthy labor market (by enabling people to locate from city to city), and the direct jobs impact connected to the housing industry.

NAHB estimates the following economic impacts from home building and remodeling.[1]

Construction of an average single-family home:

- Creates 3.05 jobs and $145,422 in wage income
- Yields $85,866 in net business income
- Generates $89, 216 in federal, state and local tax revenue

Construction of an average multifamily unit:

- Creates 1.16 jobs and $54,938 in wage income
- Yields $31,771 in net business income
- Generates $33,494 in federal, state and local tax revenue

Investment of $100,000 of remodeling improvements:

- Creates 1.11 jobs and $52,709 in wage income
- Yields $29,958 in net business income
- Generates $30,217 in federal, state and local tax revenue

Debt Financing is Critical for Small Home Builders

The use of debt is critical for the supply side of the housing market. The home building industry is dominated by small businesses. And small businesses in the residential construction sector depend on debt to finance business operations, make payrolls, and build or improve homes.

The median NAHB home builder member has 4 employees, constructs 3 homes per year, and reports less than $1 million in gross receipts. Approximately 80% of NAHB's membership consists of businesses organized as non C-Corporation entities (sole proprietorships, partnerships, LLCs and S Corporations). And very few of the 20% of members organized as C Corporations are publicly-traded corporations.

For such small firms, equity financing from Wall Street is simply not an option. The average NAHB member, be they a land developer, remodeler, or home builder, must seek business financing in the form of debt from banks. For builders, this takes the form of Acquisition, Development and Construction (AD&C) loans. It is typical with such loans for small businesses to offer up personal guarantees (effectively using personal assets as collateral) in order to attract capital to small business.

Although the residential construction sector is improving, several factors may hold back growth, including the still overly tight credit restrictions. Although the availability of credit has eased since the height of the housing crisis, small business lending is in a state of crisis, particularly for those firms in the

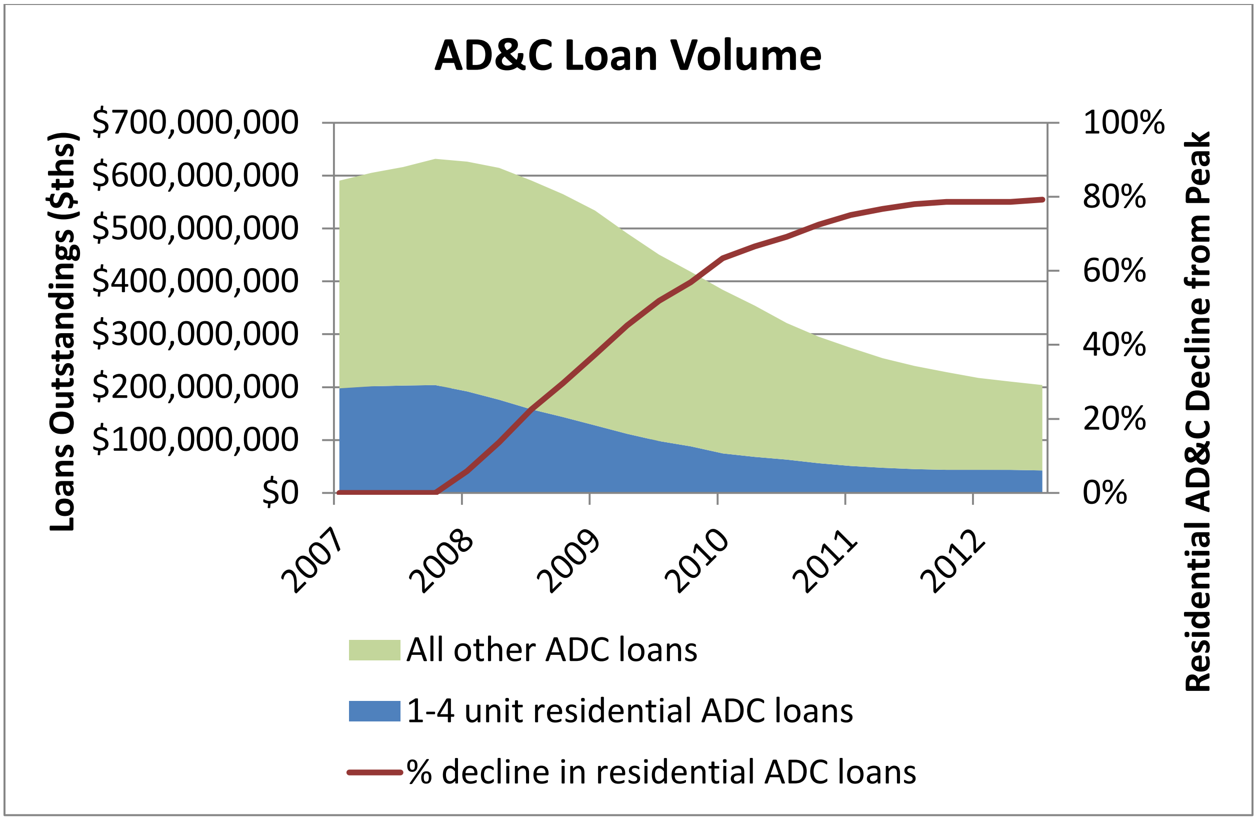
[1] The Direct Impact of Home Building and Remodeling on the U.S. Economy. NAHB Economics Group. (http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=103543&channelID=311)

residential construction industry. NAHB's membership survey shows that builders and developers continue to put projects on hold due to a lack of credit.

In the near term, a troubling development is that financing for land development is improving at a slower pace than construction. In many areas, buildable lots are growing scarce, which will translate into both higher prices until new lots are brought online but also to stalled economic growth as customers are turned away. Lot development has a lengthy time horizon, often several years, so we should be experiencing a greater uptick in lot development now to respond to expected growth in the coming years. This does not appear to be occurring due to the lack of financing, which again, will result in a drag on the housing recovery.

According to FDIC Statistics on Banking data, since the fourth quarter of 2007, loans outstanding for ADC home building purposes have fallen from $204 billion to $42 billion, a decline of 79%. While some of this decline is explained by the fall in housing construction activity, during this same period total dollar value of permitted housing construction is down only 46%. Thus, a significant lending gap has opened between actual demand for new home building and business lending available – this gap could be as a high as $64 billion[2].

[2] http://eyeonhousing.wordpress.com/2013/03/01/adc-lending-in-the-4th-quarter-of-2012/



This dramatic decline in lending can be seen in the chart above.

For these reasons, the tax treatment of debt and the prospects for a recovery in housing and the economy as a whole are directly related. Policy actions that would increase the cost of debt for homebuyers and small businesses in the housing sector would prevent job creation, undermine emerging stability in housing prices, and weaken an already lagging economic recovery after the deepest recession since the Great Depression.

For those builders who are able to get debt financing, interest expense deductibility is critical. Limiting deductions for these loans would raise the cost of business for small firms and drive many out of business, reducing job creation and competition for the sale of new homes. And the alternative, equity financing, is simply impractical for small business.

Section 108 Debt Forgiveness

As noted above with respect to AD&C lending, small businesses, and home builders in particular, also rely on debt proportionally more than their publicly-traded corporate peers. It is worth noting that as the economy emerges from the Great Recession, many home builders are dealing with tax issues arising from prior or ongoing debt mitigation efforts. Small business may be working with lenders to restructure debt due to land and home price declines in recent years. These efforts may result in interest rate reductions, term extensions, or even principal reduction. Under present law (section 108), these market-based workouts can give rise to tax liability. In 2009, the American Recovery and

Reinvestment Act (ARRA) allowed an up to 10-year deferral, but only for such events occurring in 2009 and 2010.

Ultimately, small businesses face few options when dealing with the tax fallout from debt forgiveness. When a home builder takes out a loan, they will make a personal guarantee to the bank, placing their own home, car, savings accounts, children's college fund, and so forth as collateral. Increasingly, banks require the builder's spouse to cosign to ensure assets are not hidden in a spousal account. For a financial institution to agree to forgive a debt, the home builder's financial situation is, in many cases, rather bleak. Builders who have faced a situation where principal debt is forgiven simply will not have the assets to pay taxes on their so-called phantom income, forcing the builder into bankruptcy. The tax liability is literally the last straw from these small business owners who were desperately trying to survive the downturn.

There are two means through with the tax liability can be removed: bankruptcy or insolvency. Both options, however, result in the loss of the business financing. Because a home builder's access to credit depends on their personal creditworthiness, bankruptcy can tarnish their credit records. While they are now free from their tax liability, their careers as a home builder are over. In contrast, corporations can often go through bankruptcy and emerge to find willing investors on Wall Street. NAHB believes that this is unfair for small businesses, and in a tax reform rewrite, would urge Congress to consider a limited exclusion for debt forgiveness targeted to small businesses.

<u>Carried Interest</u>

A note concerning multifamily developers and carried interest is important to make in the context of access to capital. A carried (or promoted) interest is a profits interest in a business deal that is larger as a share of the total return than the share of the initial equity investment. Under present law, if the income paid out as the carry is a capital gain, then the carry is taxed at capital gains tax rates (in general, up to 15%).

Despite the focus on the financial sector, the use of carried interest is actually quite common in real estate. A builder/developer will typically gain a carried interest in partnership with outside limited partners, who will invest a significant share of the initial equity for a project. The builder provides also provides some equity, but additionally acts as the entrepreneur and takes more of the economic risk. The return to the carry reflects this risk premium, and thus allows shifting the risk away from the limited partners and attracting capital to the deal.

For multifamily projects, the income due to a carry typically arises as profit from the sale of an apartment building, which is a depreciable, capital asset. As such, this profit originates as a capital gain. The proposal to tax carried interest would redefine such income as non-capital income and tax it at a higher rate.

NAHB analysis found that by placing downward pressure on the prices of apartment buildings and other commercial real estate, the proposal would reduce state and local property tax revenues by more than $1 billion per year and would eliminate more than thirty thousand jobs in multifamily construction and development. Given the ongoing weakness in the labor market and the potential for job creation in the multifamily sector, tax increases on apartment developers would be harmful for economic growth.

Debt Financing is Critical For Home Buyers

Home buyers provide both debt (a mortgage) and equity (cash in the form of a downpayment) when purchasing a home. Very few home buyers—only the wealthy and investors—are financially capable of providing all or most of the home purchase price in the form of cash. As a result, accessible and affordable mortgage financing of a home purchase is an essential element of a functional housing market.

The mortgage interest deduction (MID) is a cornerstone of American housing policy. Deductions for mortgage interest have been allowed for homeowners since the origins of the tax code in 1913. By reducing the after-tax cost of servicing a mortgage, the MID reduces the cost of ownership of a home. This is particularly true for homeowners in the early years of a mortgage, who are paying mostly interest and relatively little principal. For these homeowners, the MID is of great importance.

Given these realities, the use of debt to finance a home purchase is an unavoidable means. This is particularly true for younger, first-time homebuyers who have less accumulated wealth as they begin their working years. The Joint Committee on Taxation[3] demonstrated this effectively by noting that household leverage declined significantly for households headed by an individual aged more than 45. For household heads aged less than 35, the leverage ratio on average was 44.3 according to the 2007 Survey of Consumer Finances. For those aged 35 to 44, the average ratio fell to 28.2. And for those 45 or higher, the average leverage ratio was less than 16.3.

Some opponents of the MID attempt to link it to the housing crisis. Given the worldwide increase in housing prices and the long historical use of the MID, this linkage clearly fails. In fact, the JCT in their report[4], comparing the changes in tax law and historical debt levels including the years prior to and during the Great Recession, note that "[t]his appears to indicate that the tax rules by themselves do not explain the trends in household debt over this period."

In fact, eliminating or curtailing the MID would have the effect of increasing the cost of purchasing a home, thus reducing demand for homes and placing downward pressure on home prices, thus exacerbating the current economic crisis. Given what has happened the nation's housing markets, and its related and spillover consequences for that nation's economy, changing the rules with respect to home buyer demand and mortgage access is exactly what the economy does not need. Some critics of the MID claim that a reduction in house prices would "improve" affordability for home buyers. This claim assumes the homebuyer is using cash and no debt however. However, if the price of homes fell less than the after-tax increase in servicing the debt, affordability would be hurt by limiting the MID. Not to mention that this view ignores the impact declining prices has on the wealth of all the nation's

[3] Present Law and Background Relating to Tax Treatment of Household Debt. http://www.jct.gov/publications.html?func=startdown&id=3802
[4] Present Law and Background Relating to Tax Treatment of Household Debt. http://www.jct.gov/publications.html?func=startdown&id=3802, page 48.

current homeowners; for every one percent decline in home values, $177 billion in household wealth is lost.

Others have suggested long-term phase-ins of various limits for the MID. However, these proposals would also have immediate and negative consequences for housing. The typical homebuyer remains in their home for approximately 10 years.[5] Given the long-term nature of a home purchase, changes that would become effective in two, five or even ten years would have the consequence of reducing housing demand, and prices, today. And these changes would affect not only potential homebuyers, but all existing homeowners in terms of generating a windfall wealth loss through housing price declines.

Home Equity Loans

Another element of the MID that has been criticized are the rules allowing an interest deduction for home equity loans. It is important to keep in mind that according to the 2009 American Housing Survey, half of all home equity loans are used for remodeling purposes. Remodeling is of course another form of housing investment which creates jobs and improves the nation's housing stock, particularly with respect to energy efficiency. Disallowing a deduction for interest for home remodeling provides a disincentive for homeowners to improve the nation's existing housing stock and hurts job creation in the remodeling industry.

There is no data that indicates what the remaining half of home equity loans are used for, but anecdotal evidence suggests that those purposes include college expenses, health emergencies and some consumption purposes.

Remodeling and home improvement are important economic activities for a nation with an aging housing stock. Remodeling expenditures totaled $147 billion for professional remodeling jobs, according to 2009 American Housing Survey data. Every $100,000 in remodeling expenditures creates 1.11 full-time equivalent jobs according to NAHB estimates.[6] So this economic activity supported 1.63 million jobs in the construction and related sectors (such as manufacturing and retail).

In the *Tax Reform Act of 1986*, Congress differentiated between "good" debt, used for investment, and "bad" debt, which is used for consumption. The deductibility of interest on debts for car loans or credit cards was eliminated, but deductions for "good" debt such as investment into a business, home, or education was maintained. An interesting connection between housing and student loan debt shows just how important maintaining the current deductions for "good" debt is.

Alarms have been raised about the increasing levels of student loan debt. The cause, however, has a connection with housing. For parents, home equity loans became a significant means for financing their children's higher education. With the onset of the housing crisis, there was a decline in the availability of home equity loans. While many policymakers have raised concerns about the recent increase in

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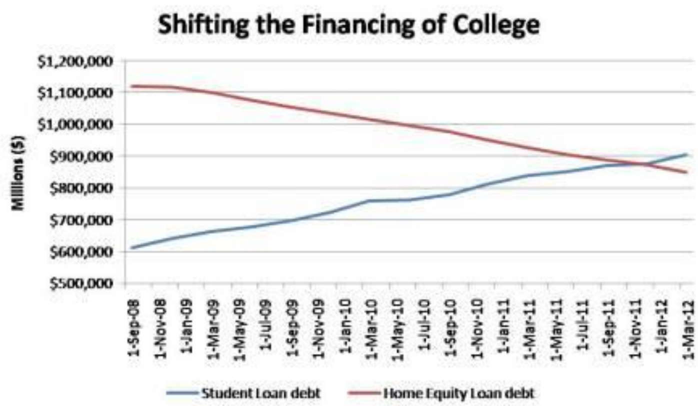
[5] How Long Buyers Remain in Their Homes. NAHB. http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=110770&channelID=311

[6] http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=103543&channelID=311

student loan debt, in part what has happened is that the source of that financing shifted from the parents (via home equity) to the children (via student loans). This can be seen clearly by tracking the amounts of both types of debt through the housing downturn:



While this cause of the rise in student loan debt is often missed by analysts, access to debt financing and the deductibility of that debt play key roles in the ability of Americans to invest in themselves, be it through a business, home, or education. To ensure we maintain a society that supports upward mobility, we must take care not to demonize debt to such an extent that its role in the development of the middle class is ignored.