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STATEMENT OF THE

NATIONAL ASSOCIATION OF REALTORS®

SUBMITTED FOR THE RECORD TO THE

UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS

HEARING REGARDING

EXPIRED AND EXPIRING PROVISIONS

APRIL 26, 2012

Introduction

More than 1.1 million members of the NATIONAL ASSOCIATION OF REALTORS® (NAR), urge you to renew or extend four of the category of tax provisions that are known as “the extenders.” REALTORS are involved in residential and commercial real estate as brokers, sales agents, property managers, appraisers, and counselors. They are engaged in all facets of the real estate transaction. All would be adversely affected if the provisions that we identify and discuss below were no longer available.

It’s no secret our nation’s housing and commercial/investment real estate markets remain fragile. When the ongoing housing crisis began in 2007, no one imagined that it would carry on so long. Today, all categories of real estate are slowly recovering, but remain in need of immediate policy solutions and legislation. We therefore urge prompt action to renew and/or extend each of these provisions. These include mortgage cancellation tax relief, the 15-year depreciable life for leasehold improvements, expensing of certain clean-up costs associated with developing brownfields properties and the first-time homebuyer tax credit for residents of the District of Columbia.

Cancellation of Mortgage Debt

REALTORS® have long maintained that the key to the nation’s economic strength is a robust housing industry. In particular, sustaining tax relief for the millions of homeowners who have been subject to foreclosure or short sales is critical. **Thus, extending mortgage cancellation tax relief is among NAR’s highest priorities for 2012.**

The mortgage cancellation relief provisions were enacted in 2007 in order to assure that homeowners would not be taxed on money that they have already lost. This important (but temporary) provision was enacted in 2007 to address a sudden collapse in the US housing market. The provision assures that individuals who lose their homes in foreclosure or suffer economic loss in a so-called “short sale” would not face a tax burden at the time of a substantial economic loss. A third category of homeowners has received less attention, but are also affected by these relief provisions. This group of responsible homeowners has remained current on their mortgages in the

face of declining home values. To the extent that lenders are willing to restructure their performing loans, any mortgage write-downs they receive are also eligible for this relief.

Until the 2007 collapse, few homeowners faced income tax problems related to mortgage debt forgiveness. Today, while the rate of foreclosures is declining, many families are still losing their homes because someone in a household has lost a job. Similarly, about one-quarter of all homeowners are “underwater” on their mortgages: they owe more on their mortgage than the fair market value of the home. Finally, lenders, both on their own initiative and through various programs, have restructured loans to allow families’ mortgage debt in order to reduce payments with lower interest rates. In fact, lenders have recently stepped up their efforts to restructure loans and to decrease the amount of time required to close a short sale. These processes, however, are unlikely to have been completed before the December 31, 2012, expiration of the relief provisions.

The mortgage tax relief provisions protect these homeowners (so long as they meet specified criteria) from facing a tax bill after an economic loss on what, for most, is their most valuable asset. Current data on so-called “underwater” mortgages (where the borrower owes more than the home is currently worth) illustrate the reality that housing challenges persist.

According to CoreLogic,¹ a leading analytics and research firm, about 22.8% of all owner-occupied, mortgage-financed homes (about 11.1 million units) were “underwater” at the end of the fourth quarter of 2011 (most current data). Notably, the fourth quarter number is *higher* than the third quarter of 2011, when 10.7 million units (22.1%) were underwater. This increase in the number of underwater mortgages underscores the persistent nature of this problem and suggests that many, many mortgages have yet to go through the system. The severity of the negative equity (or underwater) problem is most acute in Nevada, where 61% of homes have negative equity. In the five states where the problem is most acute, homeowners with negative equity average about 44% of all homeowners. (The five states are, in descending order, Nevada, Arizona, Florida, Michigan and Georgia.)

¹ CoreLogic Q4 2011 Negative Equity Report, www.corelogic.com.

Prior to 2007, if a lender forgave any portion of a mortgage debt, the forgiven amount was treated as income and taxed at ordinary income rates. The relief provisions were enacted because there was a widespread understanding that the nation's already-fragile economy would be further undermined if individuals faced heavy tax burdens in a declining housing market. The legislation was unique in at least two important ways. First, the underlying bill, H.R. 3648, was a small, housing-only bill. For a host of reasons, it is rare that Congress enacts single-issue tax legislation. The speed with which the legislation was enacted underscores the wide perception that an impending crisis necessitated quick action. The second unique element of this legislation was that it passed with an overwhelming bipartisan majority. House passage of H.R. 3648 was on a vote of 386 – 27. The Senate version passed on a Unanimous Consent agreement, and final passage in the House was on a voice vote under suspension. Hence the principle that during an economic downturn homeowners should not be forced to pay tax when they have lost money on their principal residence can accurately be characterized as non-controversial.

Failure to extend the mortgage cancellation relief would have a uniform outcome: Individuals will be taxed on money they have already lost with cash they have never received. The “income” in a mortgage cancellation transaction is, at best, “phantom” income. Tax policy has generally favored results that avoid taxation on phantom income because the affected taxpayers are often the least able to pay. Phantom income is not cash income. In this case, the phantom income is attributable to a transaction in which the taxpayer/homeowner actually incurs an economic loss. The CoreLogic report² describes the incidence of underwater mortgages as affecting mostly lower cost homes: “The low end of the market is where the bulk of the negative equity is concentrated. ... [Negative equity is found mostly among] homes valued at less than \$200,000.”

NAR continues to support timely enactment of an extension of this provision. We support both House bills (H.R. 4250 [Rangel] and H.R. 4336 [Reed]). REALTORS will be in Washington DC during the week of May 14 for their spring legislative meetings. They will be seeking additional cosponsors for either or both of these bills and for a companion Senate bill (S. 2250 [Stabenow, Heller]). **Enactment of this extension is among NAR's highest legislative priorities for 2012.**

² Ibid.

In the context of the mortgage transaction, we wish to comment on a provision that was used to “pay for” the 2-month payroll tax extension enacted in February of this year. That provision, the so-called GSE guarantee fee (G-fee), burdens the real estate transaction. We believe it would be a mistake for Congress to increase that fee in the current real estate market, as any fee increases the cost of a housing-related real estate transaction.

The Nation’s housing sector remains in a precarious state. Though we see signs of improvement, we urge Congress to take no steps that could retard that recovery and ultimately send our overall economy into another tailspin. Increasing the G-fee, even just extending the current fee increase, effectively taxes both potential homebuyers and consumers looking to refinance their mortgages, at a time when the housing sector can least afford it. We believe that any proposed G-fee increase would keep prospective housing consumers on the sideline and prevent the absorption the financial system’s large real-estate-owned (REO) inventory of foreclosed properties. Similarly, we believe that any increase of the G-fees would reduce the benefits of loan modification for those individuals who are current in their payments but underwater on their mortgages. We believe any tax law changes that affect housing should have as their primary purpose the goal of keeping responsible consumers in their homes.

Leasehold Improvements

In 2004, Congress modified the rules for the depreciation of improvements made for the benefit of tenants in leased space. Prior to 2004, if a property owner reconfigured or improved space for tenants, the cost of those improvements was recovered in the same manner as the cost of the structure itself. Thus, the cost of improvements to leased space was recovered over 39 years, even though the improvement was rarely permanently affixed to the structure, and even though the duration of the lease was significantly less than 39 years. The result was a diminution of appropriate return on the improvements and considerable tax and record-keeping complexity for landlords. These problems were particularly acute for landlords with larger, multi-tenant buildings.

The 2004 change was made to more accurately reflect the economic life of the improvements. Before the current depreciation system was put in place, the costs of leasehold improvements were recovered over the term of the lease. This method was abandoned when the depreciation system

was overhauled in 1981 and all the costs associated with the depreciation of real property were recovered over 15 years. That 15-year period was extended to 18 years in 1984, to 19 years in 1985, 31 years in 1986 and, finally, the current 39-year life was enacted in 1993. An economic depression in commercial real estate between 1986 and 1995 obscured the adverse economic impact of recovering the costs for leasehold improvements in a more economic manner than the 39-year life. As the commercial real estate market improved over the following decade, the need for a shorter recovery period became more apparent.

Even the 15-year cost recovery period is longer than the life of most commercial leases. When the provision was enacted, the term of a commercial lease was typically 7 – 10 years. Today, pending financial accounting standards could make the terms of leases even shorter. The Financial Accounting Standards Board (FASB) has proposed standards that have the effect of overstating a lessee's liability for future rents. Increasing that liability is predicted to cause lessees to seek shorter lease terms to mitigate the potential impairments to their financial statements. Shorter leases will have the effect of making the 15-year leasehold improvement cost recovery period even less economic than it is today.

The leasehold improvement has, unfortunately, always been a temporary provision. These rules, like so many provisions enacted since about 2003, are temporary because of procedural demands of the budget process, not because of any flaw in the rules themselves. In fact, the leasehold improvement rules have typically enjoyed bipartisan support. They simplify cost recovery calculations and provide an incentive for owners to improve and modernize their properties. Today's starved construction industry would be important beneficiaries of a renewal and extension of these rules. Leasehold improvements create jobs.

Accordingly, on the merits of the leasehold improvement rules themselves, and on the jobs creation capacity those rules create, NAR fully supports H.R. 1265 (a bipartisan bill with 85 cosponsors) and its companion S. 687 (a bipartisan bill with 24 cosponsors). Both bills would renew the 15-year cost recovery period for leasehold improvements and make it permanent.

Environmental Remediation Costs

In 1997, as the commercial real estate market began rebounding from the 1986 – 1995 real estate depression (see above), developers often discovered that a major obstacle to constructing new buildings and improving communities was the presence of various contaminants on the land. Preparing sites to eliminate the contaminants was (and remains) a significant cost both in terms of time and money.

Prior to 1997, the cost of cleaning up contaminants had to be capitalized into the cost of the land itself. As land is not a depreciable asset, those costs became sunk costs that were not recoverable until the property was sold. In order to achieve the desirable goal of getting properties cleaned up and put to their best use, Congress determined that the costs of environmental remediation could be deducted in the year they were incurred. This benefit expired as of January 1, 2012.

While REALTORS generally are not developers, they are often assist developers in their land acquisition activities and so have an interest in the transactions that lead to land development. To the extent that communities are enhanced by the environmental improvements, our members also benefit as the residents become more mobile and property values increase or as residents are attracted to the improved location. Accordingly, NAR has always supported the efforts of the organizations comprised of real estate developers to secure permanent rules that allow expensing of environmental remediation costs.

District of Columbia First-time Homebuyer Tax Credit

Congress created a first-time homebuyer tax credit for the District of Columbia in 1997, when both the city's population and the value of its homes were declining. The credit was intended to attract people back into the city and to be a mechanism to stimulate and support additional economic activity. By the time of the 2000 census, the credit had not been in place long enough to change the trend of declining population. Finally, by the time of the 2010 census, the District experienced a population increase. The population had been in decline since the 1950 census.

NAR, along with the Greater Capitol Association of Realtors (GCAR) which represents REALTORS doing business in the District, supports an extension of this tax credit. The District can only sustain its new-found appeal to young buyers when they come to the city and continue to make it a more alive, vibrant community. Continuing the tax credit will enhance the District's appeal. Homeownership is essential to sustaining the District's progress toward self-supporting economic vibrancy. We urge you to extend this important provision.

Conclusion

The US economy will not improve until the housing market in particular and the broader real estate market are on an upward trajectory. Each of these provisions would help stabilize and sustain both the housing and the commercial real estate markets. We urge their timely renewal and/or extension.

Questions related to this statement can be directed to NAR's Tax Counsel, Linda Goold. She can be reached at 202 383 1083 or at lgoold@realtors.org.