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TAX CREDITS FOR RESOLUTION TRUST CORPORATION PROPERTY SALES

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION

OF THE

COMMITTEE ON FINANCE UNITED STATES SENATE

ONE HUNDRED SECOND CONGRESS

FIRST SESSION

ON

S. 1787

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TAX CREDITS FOR RESOLUTION TRUST CORPORATION PROPERTY SALES

TUESDAY, OCTOBER 22, 1991

U.S. SENATE,
SUBCOMMITTEE ON TAXATION,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 2:37 a.m., in room SD-215, Dirksen Senate Office Building, Hon. David Boren (chairman of the subcommittee) presiding.

Also present: Senator Breaux.

[The press release announcing the hearing follows:]

[Press Release No. H-45, Oct. 10, 1991]

SUBCOMMITTEE PLANS HEARING ON TAX CREDITS FOR RTC PROPERTY SALES, FOCUS ON BREAUX PROPOSAL

WASHINGTON, DC—Senator David L. Boren, Chairman, announced Thursday the Finance Subcommittee on Taxation has scheduled a hearing to consider tax credits for Resolution Trust Corporation (RTC) property sales.

The hearing will be at *2:30 p.m., Tuesday, October 22, 1991* in Room SD-215 of the Dirksen Senate Office Building.

Boren (D., Oklahoma) said the hearing will focus on S. 1787, the Asset Disposition and Revitalization Credit Act of 1991, authored by Senator John Breaux (D., Louisiana), a member of the Finance Committee. The bill would offer purchasers of RTC commercial property a tax credit of up to 80 percent of the purchase price to be recovered over 5 years. The Subcommittee will explore whether and how the Asset Disposition and Revitalization credit would provide incentives to investors to buy property—removing it from RTC inventory and stabilizing declining real estate values—and other issues raised by this approach to facilitating RTC sales.

"The slump in the real estate industry, for which the tax code is partly to blame, has had a devastating impact on our financial institutions and deserves attention by the Subcommittee. I look forward to hearing the views of government and industry witnesses on Senator Breaux's innovative proposal," Boren said.

Breaux said, "The Resolution Trust Corporation has recently asked the Congress for $80 billion, raising the tab for the savings and loan bailout to $160 billion, or four times the original estimated cost. American taxpayers do not have bottomless pockets and should not be expected to carry the extreme financial burden of holding and maintaining the excess of RTC properties. The current process is not good enough. It's time for new solutions that work."

OPENING STATEMENT OF HON. DAVID BOREN, A U.S. SENATOR FROM OKLAHOMA, CHAIRMAN OF THE SUBCOMMITTEE

Senator BOREN. I apologize as always. We cannot control what is going on in either the House or the Senate and I understand there is a vote in the House; there is going to be one in the Senate shortly. So the members of the House panel have had to go back over to the House side to vote. So I think we will briefly change the order in just a moment.

Today the Subcommittee will hear testimony on S. 1787, the Asset Disposition and Revitalization Act introduced by my colleague, Senator Breaux. It is no secret that the real estate industry is in trouble. The slump that began in the industry in the southwest has spread all across the country. The effects of the slowdown threaten not only the real estate and construction industries but the very foundation of our financial institutions —banks, insurance companies, pension funds alike.

It is also no secret that I believe that the Tax Code is at least partly to blame for this calamity. In an effort to eliminate real estate tax shelters, the so-called Tax Reform Act of 1986 went overboard and established a punitive passive loss schedule that stifles even the most legitimate real estate investment.

Unlike other industries for which losses are deemed active or passive by a material participation test, all real estate losses are deemed as passive and therefore cannot be offset against active income even if the taxpayer is in the real estate business full time. For that reason I have introduced S.1257, co-sponsored by over 30 Senators, including 9 members of this committee, which would establish a material participation test for the real estate industry.

Senator Breaux's bill, the subject of today's hearing, is another attempt to address the real estate slump by jump-starting investment in certain RTC properties and by authorizing $1 billion in asset disposition and revitalization, ADR credits, to be made available to qualified investors.

Senator Breaux's bill is interesting and innovative. I look forward to reading today's testimony on the bill, its affects on the real estate market and the Federal budget. Many in the real estate industry have expressed some concern to me that this effort might supplant the much needed passive loss changes contained in S.1257. But I think that most of us would agree that there is plenty of room to provide help that is so badly needed in the real estate business. I do not view these efforts as a mutually exclusive, one of the other, but certainly as complementary.

We are in a familiar situation now of making revenue estimates of what we are going to pick up in terms of revenue for the Treasury. These estimates are made on a static model basis, without taking into account all the practical effects on the economy.

When we consider the degree to which the real estate collapse has driven up the cost tremendously in terms of the collapse of the savings and loan industry and much of the banking industry in this country, I think we would certainly agree that any idea that we were going to have a huge revenue gain to the Treasury from some of the changes that were made has certainly been proven without a doubt to have been mistaken.

I welcome this opportunity to hear testimony on the bill by Senator Breaux today. I have explained to him that I have been called to a meeting on confirmation process reform down at the White House with the President in a few minutes. So I may have to be in and out of the hearing. Senator Breaux will continue them if I do have to leave.

I will read the record with interest because this is a proposal that has a great potential impact on my own home State as well as upon many, many others across the country that are now in distress. We all realize that the continued overhang in the market of a significant amount of space that is not moving and that is unoccupied keeps prices even more depressed than they would otherwise be and presents both a management and a financial burden to the government as well.

So I want to commend my colleague for this very innovative idea. I know that all the members of the full Finance Committee will read with interest this testimony and give full consideration to it as the committee decides how to proceed from this point forward.

I first would like to ask Senator Breaux if he has any opening comments as author of the bill that he would like to make.

OPENING STATEMENT OF HON. JOHN BREAUX, A U.S. SENATOR FROM LOUISIANA

Senator BREAUX. Thank you very much, Mr. Chairman, for your comments. I will be pleased to help with the hearing.

Let me just say, Mr. Chairman, in a short while Congress will be asked to consider yet another funding request for the Resolution Trust Corporation. In mid-August Treasury Secretary, Nicholas Brady, and the Federal Deposit Insurance Chairman, William Seidman, appeared before Congressional committees requesting $80 billion in additional funding for the RTC.

More recently the Congressional Budget Office and the General Accounting Office have testified that this additional funding of $80 billion will not be sufficient and that billions more in taxpayer dollars will be needed to bail out the savings and loan industry.

In 1989 $50 billion was appropriated for the RTC. This spring we provided an additional $30 billion and now here we are again just 6 months later with a pending request for another $80 billion. This will bring the total bail out costs so far to $160 billion to pay for what was originally estimated to be a $40 billion problem. This $160 billion does not even include the borrowing authority that RTC has to use as working capital.

Mr. Chairman, we are throwing money down the sink hole with no clear idea of how we can stop this hemorrhaging of the Treasury. And to add insult to injury much of the property that is being acquired by the RTC is simply being held unpurchased and costing the government billions to hold and to maintain. Although the RTC has been modestly successful in paying off the depositors and marking their huge financial portfolio real estate assets are selling at an extremely slow pace.

In spite of a few well publicized sales the RTC has sold less than 5 percent of its entire portfolio of assets and according to the GAO is holding an inventory of commercial property worth $7.9 billion. Neither the taxpayer nor the real estate industry can continue to support this growing supply of government-owned real estate.

Under current law the RTC has options of disposing its real estate assets. It can reduce the price. However, there are clear anti-dumping rules in the statutes to prevent devastating local real estate markets, especially in distressed areas. And under these rules the properties can be sold at 80 percent of appraised price within

6 months of marketing, 60 percent from 6 to 18 months, and at 50 percent from 18 to 24 months.

In addition the RTC is talking about implementing flexible financing programs. The RTC can also provide seller financing at great risk to the taxpayer. For if the purchaser defaults, the RTC takes back the property at a loss.

Mr. Chairman, the problem is that the real estate markets are depressed everywhere. Much of the property is risky property to start with, properties that banks would not want to lend money on. Even at the statutorily allowable reduced price where are the buyers? It is very clear to me that the slow pace of these asset sales demonstrate that there are no buyers.

While there are no buyers the taxpayer bears the burden of holding the properties, paying the insurance, the taxes, the operation and maintenance. Mr. Chairman, the government is not a good landlord nor stewart of these properties. As these properties are held they also are deteriorating in value. According to an economist we will hear today there is a point where it would simply be cheaper to have the property given away than to continue to hold the property.

This hearing today is about encouraging the private sector to purchase the properties. We need to look beyond economic theories on what is efficient and not efficient and look to what it will take for individuals to purchase the property. Clearly, the current system is not working.

We need to give the private sector a reason to purchase these properties and I believe the tax credit offers a useful alternative. Briefly, it authorizes $1 billion of tax credit, provides that the RTC and the FDIC the discretion to allocate the credits and would provide the credit only after other alternatives to sell the property have been fully explored and provide to the RTC and the FDIC the discretion to authorize a credit of up to 80 percent of the purchase price of the property spread out over 5 years.

It also provides that any person who sells, exchanges or disposes of the property with respect to which the credit is allowed will be required to pay the RTC in an amount equal to 20 percent of the amount realized or of the fair market value. It also provides for a $50,000 exemption from the passive loss rules and will be allowable against alternative minimum tax.

Our proposal is expected to stabilize the declining real estate values, democratize the RTC property sales processed by permitting average investors to participate through the syndication process. It would save, Mr. Chairman, taxpayers an estimated $2 for every $1 used to finance the program.

Mr. Chairman, I hope that we all can keep an open mind and look beyond the economic predictions in economists statements to what the taxpayers are telling us—enough is enough. We need to get the government out of the real estate business and to minimize the cost of the bailout. This project, I submit, is a reasonable alternative that needs to be considered.

Thank you, Mr. Chairman.

Senator BOREN. Thank you very much, Senator Breaux.

Congressman Orton has returned. I see Senator Kerry here. If you would like to join the Congressman. We will have our Congressional panel. Congressman Ridge has also joined us. We welcome you. We are sort of sandwiched in it looks between votes in the House and the Senate. I think we are going to have a vote commencing in the Senate. Maybe that was it, right on cue, very shortly here. No, not quite yet, but it is supposed to happen in a minute.

So I might, if my colleagues from the House will not mind, since Senator Kerry will probably have to leave in about three or four minutes, and this will be good training to put Senators under time limitation in this fashion, allow our colleague to go first, then I will suggest Senator Breaux might want to go to the floor and vote and then return and then I will go vote when you get back. That way we will be able to keep the hearing moving if we possibly can.

Senator Kerry, we are happy to recognize you at this time.

STATEMENT OF HON. JOHN F. KERRY, A U.S. SENATOR FROM THE STATE OF MASSACHUSETTS

Senator KERRY. Mr. Chairman, thank you very much. I appreciate it and I appreciate my colleague's indulgence. I am under a time limit because I am chairing a BCCI hearing right now and obviously I am here and not there. That is a problem.

I am delighted to testify in favor of the asset disposition and revitalization credit act of 1991. I am a co-sponsor of that bill and I think it is an important step. I commend to this committee an effort to try to move this rapidly.

When one talks to anybody about the economy in this country and the problems we face and why we did what we did in 1986, it is almost axiomatic that in 1981 the Congress passed a series of measures that went too far in exciting private capital to move to real estate investment. There is almost no one who does not say we did something wrong.

Too much incentive was established to pull the capital into that market place. Indeed, I think we built over half the office space of this country in the span of some 6 years. Now that was not a good decision, but it does illustrate one important thing. It is extraordinary evidence of the power of the Tax Code to induce behavior. And, indeed, the people who have followed the theory of tax expenditures over the years subscribe to the notion that without getting into too much bureaucracy of making decisions, tax expenditures often are an effective, efficient way for the government to create a framework which the private sector can use to decide what it wants to do with capital.

Congress created too broad a framework in 1981, so in 1986 we stepped back. The problem is that in 1986 we took almost 20 percent of the GNP of this Nation and just sucked the guts and value out of it; as a result, we are inheriting the wind in the banking structure of this country because of what happened to property values. They are gone. It has become a vicious cycle. Not just in New England, but all over the country. The regulators sit there and say to the banks, "You have too much real estate in your portfolio so you have to mark it down."

The reduction in market value of that real estate is reduced as a result of the capital coming into the market to sustain those values. This causes the regulators to look at loans with real estate collateral—almost any business loan—and say, "This collateral is overvalued. You have a problem. We are going to call your loan."

The result is that multitudes of businesses—even those that are current in their loan payments—and I can give you specific examples all through Massachusetts—are having their loans called. This is depressing every other aspect of the economy. Every subcontractor, every business that might want to do business with those businesses, suddenly is slowed down, pulled away, deterred, and you create a psychology in the entire economy of this country that is incapable of finding optimism and a reason to invest.

Now I know we do not want to create a new, false real estate market. I understand the rationale of the 1986 tax changes although I opposed getting rid of some of those incentives because I think they were an important part of what drives the economic engine of this country. But we have a serious problem now—particularly in New England, but also throughout the country. And it is a problem of valuation.

This country does not have to fear inflation right now. It ought to fear deflation. So what we ought to do is take the lesson we learned in 1981 and apply it to our current circumstance. We should put back some of that real estate value and attract private capital into the market place again to invest in small and middle-size businesses.

If you leave the RTC the way it is today as the largest government propertyholder, the only capital available is that in the hands of real estate people already in the market place. But you cannot possibly attract any other new capital or investors. Other investors simply are waiting for the distressed property to reach a bottomed-out value, at which time they will buy.

On the other hand, if you artificially increase the value of those assets by creating a tax credit, and that causes an investor to make a purchase, that not only has a benefit in getting rid of your current surplus of property, it has the important spinoff benefit of contributing some value to all the other property that currently is clogging the market place, which is being dragged down as a consequence of the bargain basement sales for which investors are waiting with the government-held property.

I commend Senator Breaux for introducing this legislation because I think that this relationship is what he has recognized and what we in the Congress ought to recognize. We know that tax expenditures can work. It is their abuse that we were really trying to stop in 1986, not their beneficial use. I think we, to a certain degree, threw the baby out with the bath water back in 1986, and a lot of us predicted that that bill, the undesirable features of which we thought we would correct sooner than this, was going to rip the guts out of the real estate market place and, indeed, that is exactly what it has done.

I think, Mr. Chairman, that the $1 billion limitation in this bill is frankly not enough, but it is a beginning. And at least it would constitute a Congressional decision that we are not just going to sit around on our hands and wait for the next request for $180 billion more than we on the Banking Committee already have approved to bail out the banks and S&L's. To minimize failures and bailout costs, it is essential to move property at reasonable prices.

If you create this kind of incentive you will greatly enhance the market place. You will restore some optimism. You will send people a signal that Congress is willing to do more than just spend their tax dollars on a crisis management program and you will restore some value to other parts of the market place that desperately need it.

That is a quick summary. Mr. Chairman, I really think it is important for us to get off the dime here and get something going. This economy needs a shock from the administration, from us, to snap people out of the stupor that we are in in terms of consumer confidence, and this is the kind of measure that I think can help do it.

Senator BOREN. Thank you very much, Senator Kerry. We will receive your full statement for the record.

[The prepared statement of Senator Kerry appears in the appendix.]

Senator BOREN. Let me just ask one brief question. Some have argued, and you have touched on this already, but some have argued that we are in essence showing preference for some kind of property over others. We have a market that is depressed in general. This bill would provide the credit for those held by the RTC, by government, as opposed to private sector lenders.

Senator KERRY. Correct.

Senator BOREN. I wonder if you have discussed this specifically with those that are holding assets that are financed otherwise, not by the RTC.

Senator KERRY. Yes I have.

Senator BOREN. And if they would favor the bill nonetheless on the basis of the impact it would have on stabilizing market value.

Senator KERRY. That is a concern that has been expressed by some parties. I personally would prefer a broader program. I think simply limiting the credit to the RTC could create some imbalance. But the imbalance is preferable to taking no action.

Yes, it does create a certain inequity. But I think the restoration of value to other real estate, realized by buttressing up the values of RTC-owned properties, is a benefit that accrues to everybody else. And whether one is in bankruptcy proceedings or simply in distress and workout, he is going to have an opportunity to get a higher price and to get a better workout by virtue of the marketplace getting this infusion.

Does it discriminate? Yes, it does. I personally would rather see a broader effort by Congress to deal with all distressed properties. I also would like to find a way of defining a sham bankruptcy or transaction to stop people declaring in order simply to qualify for a credit, but people are declaring bankruptcy today for those reasons. It has almost become a way of doing business in the United States as a consequence of the condition we are in.

In fact, I will give you an example quickly. A man in Massachusetts who has done business for years could not get any banks to listen to him recently. He had a lot of outstanding problems. He called the banks and told them, "I really want to work this out," and he could not even get an answer. Nobody wanted to deal with him. He declared bankruptcy and every single one of those banks was at his door the next day saying, "God, we did not know you were going to go to bankruptcy," because all of a sudden, he stopped paying interest. A person has protected himself the moment he declares.

So the banks do not get anything. As long as they were getting what they wanted they did not care about the situation. But the moment bankruptcy was declared and interest payments were cut off, they were there to figure out how to work it out. I think you will encourage that kind of workout with this bill and you will deal with the inequity.

Senator BOREN. We had a lot of the same arguments raised when I was chairing the Farm Credit Subcommittee. Some people who did not owe money on their land or who had been current said, well, why should there be restructuring provisions to help my neighbors. One of the answers for that was, if their neighbors' land all went into foreclosure and fire sale prices, then the asset which usually represented the life savings of the neighboring farmer was also greatly depreciated through no fault of that other farmer.

So there was an interest. Even though sometimes there can be some element of preference alleged there still is an interest in getting the home market stabilized and everyone would benefit from it.

Senator KERRY. The entire real estate market would benefit. And taxpayers would benefit st

Senator BOREN. Right.

I am waiting for Senator Breaux to come back. I think we are down to about six minutes.

Senator KERRY. I had better go vote.

Senator BOREN. Senator Breaux will come right back. I apologize because I would rather not disrupt you in the midst. So Congressman Ridge and Congressman Orton, we will return to you just as soon as Senator Breaux gets back; he will resume. My apologies to you. Thank you for your patience.

[Whereupon, the hearing recessed at 3:00 p.m. and resumed at 3:09 p.m.]

Senator BREAUX. The committee will please come to order. I want to apologize for the numerous interruptions. But we are going to get through.

We want to welcome up, representing Treasury, Hon. Michael Graetz, Deputy Assistant Secretary of Treasury for Tax Policy and anyone that you have to accompany you. We are pleased to receive your testimony.

STATEMENT OF HON. MICHAEL J. GRAETZ, DEPUTY ASSISTANT SECRETARY OF TREASURY FOR TAX POLICY, ACCOMPANIED BY LLOYD CHAISSON, VICE PRESIDENT FOR MANAGEMENT, FINANCE, OVERSIGHT AND EVALUATION FOR THE RESOLUTION TRUST CORPORATION OVERSIGHT BOARD, WASHINGTON, DC

Secretary GRAETZ. I am pleased to be here today to present the administration's position with respect to S. 1787, a bill to provide a new tax credit to purchasers of real property held by the Resolution Trust Corporation. With me is Lloyd Chaisson, Vice President for Finance, Management, Oversight and Evaluation of the RTC Oversight Board.

Although the administration fully supports efforts to minimize the costs of the savings and loan clean up we object to the RTC property credit for a number of reasons. Senator Breaux, since in your opening statement you described the bill I will proceed straight to the administration's position, but I request that my entire statement be placed in the record.

Senator BREAUX. Without objection.

[The prepared statement of Secretary Graetz appears in the appendix.]

Secretary GRAETZ. The administration opposes S. 1787. The idea of using tax incentives in the context of a savings and loan program is not a new one. In 1981 the Congress coupled substantial tax incentives with direct financial incentives for savings and loan associations.

During 1988 and 1989 the Federal Savings and Loan Insurance Corporation (FSLIC) resolved 199 insolvent institutions and 96 assisted transactions that combine direct financial benefits and tax savings. The tax benefits were considered necessary because FSLIC did not have the financial resources to liquidate insolvent institutions even where liquidation would have minimized the costs of resolving the institutions.

The nation's experience in combining tax and direct financial benefits in these transactions has not been a happy one. Indeed, the combination of tax and direct financial benefits in the 1988 and 1989 transactions has created perverse incentives for institutions to hold assets and to minimize their value when sold, as well as incentives to maximize expenses in some cases.

In enacting the Financial Institution Reform Recovery and Enforcement Act of 1989 (FIRREA) Congress repealed the special tax benefits available to the 1988 deals making the judgment which remains sound today that the creation or maintenance of artificial tax driven transactions should be avoided because they ultimately will increase overall costs to the Federal Government.

Although S. 1787 contains limitations on the total amount of tax credits that could be claimed and thereby avoids the unlimited blank check aspects of some prior tax incentives it presents major difficulties. S. 1787 empowers a Federal agency, the RTC, to delivery tax reductions and amounts it selects to taxpayers it chooses in circumstances where others who purchase similar assets, whether from the RTC, other Federal agencies or from private sellers will not enjoy such tax relief.

This legislation inevitably will produce different tax burdens for similarly situated taxpayers and will foster perceptions that the tax system is unfair. This seems particularly like to occur in circumstances such as these where the RTC can best reduce its own costs by channeling these tax credits to taxpayers with sufficient taxable income to make the tax benefits readily usable without delay.

Moreover, the tax credit provided in this legislation is not the most efficient means to achieve the legislation's goal of expediting RTC's sales of real property in circumstances where that property is expected to have significant management maintenance and other holding costs. Analytically, it is clear, for example, that in circumstances where savings to the government are possible from the

RTC selling property sooner and reducing its holding costs, the proposed tax credit would be more costly for the government than a reduction in the RTC's minimum price for accepting bids.

Buyers who face higher borrowing costs in the Treasury will value the tax credit which is spread over 5 years using a higher discount rate than the Treasury. Buyers might also discount the value of the tax credit to reflect the risks that the full credit might not be used. This could occur, for example, if subsequent legislation were to restrict the use of tax credits, if a buyer were to sell the property within five years of the purchase date or if the taxpayer has insufficient taxable income to fully use the credit in one or more of the taxable years of the relevant five-year period.

There is no economic rationale for offering buyers a tax credit in lieu of explicit price reductions or rebates. As a result, the credit proposed in this legislation would add unnecessarily to the government's costs of the savings and loan clean up.

Proponents of the tax credit approach claim that tax credit would expand the number of potential buyers who have sufficient equity to buy RTC property. The tax credit, however, would be of value only to potential buyers with sufficient taxable income.

Accordingly, tax exempt entities, such as pension funds and foundations, nonprofit organizations which have been important purchasers of multi-family affordable housing properties and other potential buyers lacking inadequate tax base would not value a tax credit.

S. 1787 also provides exemptions for the RTC property credit from the generally applicable provisions of the alternative minimum tax and the passive activity loss rules. The minimum tax and passive loss rules were cornerstones in implementing a principal goal of the Tax Reform Act of 1986 the elimination of tax shelters and their destructive affect on the nation's economy.

The proposed exceptions in this legislation to the minimum tax and passive loss rules would not only limit the scope of these important rules but would also invite their further future erosion.

Finally, the Internal Revenue Service would be burdened with the cost of monitoring compliance with the detailed credit provisions for many years following the property's disposition by the RTC.

This concludes my prepared remarks. Mr. Chaisson and I would be pleased to answer any questions that you may have.

Senator BREAUX. Well thank you very much for that ringing endorsement. Let me see if I can understand the objection of the administration on the legislation. I guess what I am hearing is two things. Number one, that tax credits when we have tried them in the past really have not worked very well; and secondly that the better way of doing it is reducing the price.

Let me ask some questions about the reduction of the price as the best way of getting rid of the property. I cannot see how we can argue that that is working very well. The information we have is that to date RTC has only sold about one-fourth of your total real estate holdings.

Secondly, the concern that many people have is that while reducing the price may get rid of the property is the affect on other property in the same area. I mean I have examples of sales in Louisiana, land auctions, where they tell me that, you know, 20 percent to 30 percent of the property value of similar property in the area is what these auctions are going for. That in my opinion has an incredibly negative affect on surrounding real estate in that area. We can keep reducing the price, but what does it do to values in the area of other non-RTC properties.

The third thing is that it seems to me we just do not have enough buyers. What we have to do is start getting new buyers into the market. This is one way to do it.

As far as the old tax credits in the past that did not work, I mean I appreciate that. But it is like comparing apples and oranges. I mean we are talking the 1988 deals really were not open to the public, were basically private transactions. This is something that is available to the public and there is a safety net here the administration regulates and controls how much of a tax credit is going to be given. You do not have to give up the 80 percent, give whatever it takes to move the property.

But all of these safeguards, I think they adequately address the concerns that you have raised in the legislation and I would like to hear your comments on that.

Secretary GRAETZ. Senator Breaux, let me make two or three comments and then I would like Mr. Chaisson to respond about RTC dispositions.

I agree with you that the bill does contain safeguards that are important and that have not always been present when tax incentives have been offered. It limits the revenue loss and it provides the RTC with the power to deny tax credits in circumstances where it does not believe them to be either necessary or appropriate.

On the other hand, this is a tax credit that is limited to property owned by the RTC and in that sense has some of the same elements of private transferability of tax credits that we did experience in the 1988 context.

In addition, this bill because it does not adjust the assets depreciation basis for the amount of the tax credit will mean that in some circumstances, for example when the full 80 percent credit is awarded, the total tax benefits will exceed the current value of the property, so that there will be a tax incentive simply to buy the property without regard to any underlying fundamental values.

The history of the tax shelter industry in the United States suggests that if there is one thing we should be particular cautious about, it is creating a departure from fundamental economic values in the market place for assets. That is a matter of concern to us.

Senator BREAUX. Well in that point aren't we doing it every time we just continue to reduce the price? I mean we are working on situations where assets are being given away at a fire sale or just given away. We are doing that already and we are not getting rid of the problem.

Secretary GRAETZ. Senator Breaux, I want to have Mr. Chaisson respond about the RTC's disposition of properties because I think there are some facts that he could bring to bear. I do want to say, however, that I think it is likely that providing an investment tax credit on particular property owned by the RTC will be perceived in the market as very similar to a price reduction for that property.

Essentially, you are giving the price reduction through the tax credit rather than directly.

Senator BREAUX. But would you not agree on that point that at least you are maintaining the price of property in an area which would not in turn have a negative affect on other existing property in that area?

I have a property in Louisiana, I will tell you, that has been for sale for a long time; and when RTC comes in and dumps something on the market everybody else's property values go down right along with it. A tax credit would not allow that to happen.

Secretary GRAETZ. But, Senator Breaux, I do disagree with that because if you are sitting there with one property in Louisiana next to an RTC property and both sellers want to sell and the RTC has the ability to say I will give you a tax reduction through an 80 percent tax credit the only alternative for the neighbor who owns the property next to the RTC's property is to lower the price. So I think you are going to get some of the same kinds of price effects with this tax credit as you would with a direct price reduction.

Senator BREAUX. Well the price of the property that is sold is a reasonable, fair market price. That is what goes on the books.

Secretary GRAETZ. But the buyer and the seller are going to take into account the fact that the RTC property essentially is getting a tax reduction. They are buying the property and the tax reduction and not just the property. I think that will affect the property values.

Let me have Mr. Chaisson respond to your questions about the RTC's disposition of assets.

Mr. CHAISSON. Senator, today we have sold 30 percent of real estate that has come into the coffers of RTC.

Senator BREAUX. So 70 percent is still there.

Mr. CHAISSON. Thirty percent.

Senator BREAUX. Valued at how much?

Mr. CHAISSON. I am sorry?

Senator BREAUX. How much is the value of the 70 percent that remain?

Mr. CHAISSON. We have sold $8.2 billion and book value out of the $22 billion that we currently have in inventory.

Senator BREAUX. So what is the inventory value of the property that remains?

Mr. CHAISSON. $22.9 billion.

Senator BREAUX. And that represents that percentage of the total property?

Mr. CHAISSON. That is the entire REO.

Senator BREAUX. How much is left from what you originally picked up?

Mr. CHAISSON. $22.9 billion is left.

Senator BREAUX. And what percentage of the total amount is that?

Mr. CHAISSON. Of all inventory, about 12 percent of all RTC assets.

Senator BREAUX. Of the real estate, commercial——

Mr. CHAISSON. No, of all assets.

Senator BREAUX. Well of the commercial real estate, what percentage is that?

Mr. CHAISSON. Commercial income producing real estate is about 33 percent of all REO. In fact, I have a breakdown here I would be happy to submit for the record which shows all the various asset types of income producing properties that RTC currently owns.

Senator BREAUX. Let me ask you this: Am I wrong when I say to date, RTC—and if I am wrong, how am I wrong—has only sold one-fourth of the total real estate holdings?

Mr. CHAISSON. That is roughly correct. It is 30 percent now. You said 25 percent.

Senator BREAUX. So is it correct to say that you have 70 percent of your real estate holdings still left valued at $22 billion?

Mr. CHAISSON. That is roughly correct, yes.

Senator BREAUX. And you are asking Congress for another $80 billion?

Mr. CHAISSON. That is correct. The administration is asking for $80 billion.

Let me make one point on pricing. Last spring RTC, as you noted in your opening statement, implemented a new pricing policy where during the first 6 months they are permitted to sell a property at 80 percent of appraised value. I should note that that 80 percent is not necessarily the price they get. They will get something between 80 percent and the appraised amount.

After 6 months that discount deepens down to 60 percent. That is not to say that properties will be sold at 60 percent, perhaps some place between 60 and 80 percent. As you noted after 18 months that figure reduces down to 50 percent.

If during the course of selling it becomes apparent that the appraised value is wrong or does not accurately reflect some indication of what the property is worth, RTC has a process where those appraised values can be appealed and properties sold below those percentages during that time period.

Senator BREAUX. How much below?

Mr. CHAISSON. It depends on the appeal to the committee.

Senator BREAUX. Is there a bottom limit?

Mr. CHAISSON. Is there a bottom limit? No, there would not be a bottom limit.

Senator BREAUX. So you can drop it all the way down to bare bones, practically giving it away legally?

Mr. CHAISSON. Yes.

I should point out some of this real estate is not the most attractive real estate around. A lot of these income-producing properties have a negative cash flow. RTC has a program called the SANDA program where it puts a lot of these income producing properties in for management in trying to ready those properties for sale.

Senator BREAUX. Does anybody at RTC have any figures on how much it is costing RTC to maintain property that you have not been able to sell, in terms of insurance, upkeep, maintenance, whatsoever, plus depreciation?

Mr. CHAISSON. Yes. I have some figures. From January through August 1991 carrying costs of all real estate, that is receivership as well as conservatorship, were approximately $420 million. That is split between conservatorship of approximately $115 million and receivership of $295 million.

Senator BREAUX. Is there a point in which it would pay RTC is just give away some property rather than to continue to maintain it, insure it, et cetera?

Mr. CHAISSON. Well for your income producing properties it is probably best to try to ready them for sale as best as you can. Some of these properties were not properly managed. Obviously, that is the case. They were foreclosed upon at some point. I suspect perhaps in some situation there may be a property that has no residual value for some reason.

Senator BREAUX. What is your opinion as to why the properties are not selling that RTC has under your control now? Aren't enough buyers? Price too high? What do you tell people when they ask you as to why 70 percent of the properties are still there?

Mr. CHAISSON. Many of the hard to sell income producing properties have been placed under the standard asset management contracting agreement—I mentioned the SANDA program—within the last year. It takes time to get these things ready for sale. We expect very soon that we will know exactly how this program will be performing.

Senator BREAUX. Maybe Treasury, maybe it is your question. If you are concerned about the tax credit costing money, I mean you all would have total control over it. I mean you can give the whole tax credit or whatever is needed in order to get the property moved at a reasonable fair market value.

Secretary GRAETZ. Well the RTC, as I understand the bill, would have the authority to give up to $1 billion of value of tax credits. So the RTC would have the option. I guess that there really are the two concerns that I mentioned earlier.

One is that you are creating a tax advantage for a particular property and distinguishing—you are advantaging RTC property with the tax benefit that other property would not have and at the same time we simply do not see—we think it would be more costly because the value of the tax credit will not equal dollar-for-dollar value of a price reduction because buyers are going to discount that tax credit for a number of uncertainties and they will discount the tax credit because their discount rate is going to be higher than the government's discount rate.

We just do not see any advantages to tax credit as compared with the alternative of reducing price in those situations where that trade off is the appropriate trade off.

Senator BREAUX. Well one of the big advantages and you disagree with it is the fact that you do not distress the real estate values in an area. You keep the property at a fair market value that is reasonable and does not blow to hell the other property located in the same area.

Because I will tell you from Louisiana I have seen it happen. A building comes in and you keep lowering the price and lowering the price until you finally get somebody knowing that you are going to continue lowering it to buy the property at 20 percent of what its value really is and that has an affect on the property in the surrounding areas, in the neighborhood and on the same city block. I have seen it, where people have private sales up there and you sell an RTC apartment building or commercial piece of property for 20 percent of its value, that has a negative affect on everybody else.

Secretary GRAETZ. Senator Breaux, I would not disagree that there ought to be caution exercised in the trade off as to when to reduce prices. That is, I am not suggesting that the RTC should reduce prices, you ought to simply willy-nilly reduce prices. All I am saying is that if the choice, if the policy choice is one between a price reduction and offering the person who buys the RTC's property a large reduction in taxes that they can use otherwise they would not be there bidding for that tax credit.

But you are going to have the same affect on the neighbor's property. We really do not see that the difference between those two policy instruments is going to be significant when the choice is between them.

Senator BREAUX. There is no difference if neither one of them works. I would admit that. You know, if neither one of them works you have the same result.

But if one encourages people to come forth and become buyers and buy the property and it works as opposed to what we have now where you are coming back to Congress for another $80 billion on top of an $80 billion and you still have 70 percent of the properties that are still there, I would submit that it is not working.

What I am suggesting is a pilot program, not something locked in concrete forever, a small pilot program that will probably end up saving you $2 for every $1 that it costs.

Secretary GRAETZ. Mr. Breaux, I think that what Mr. Chaisson was saying is that in the last couple of years the RTC has engaged in a number of programs where they have set goals for the sales of property and have been successful in selling them. And that if you look at their experience recently and the programs that are coming on line that we have these programs in place, and as I understand it the oversight board believes that they are working.

Senator BREAUX. Well I would submit that the expectation of you continuing to lower the property values is not working. That certainly has a negative affect on the property values in an area. If they know you are going to lower the price each month that you do not sell it buyers are sitting back and waiting so that they can get it at a fire sale price.

Then when they finally do get it at the fire sale purchase price it has an adverse affect on everything in the surrounding community. I am suggesting that we ought to at least take a look and put in a pilot program that would offer some incentives in a public manner that RTC has control over how much you are going to use to see if it would work.

I mean why are we so closed mind on trying something innovative other than just reducing the price? I mean how many times can you come back to Congress and say $80 billion, $80 billion again and again?

Are you so locked in concrete that you are not looking for something innovative other than reducing the price of a piece of property? Is there some thinkers down there with some original ideas? If it is not this one, give me something else.

Mr. CHAISSON. Senator, I would like to describe some of the things the oversight board has done. Last year in response to the credit crunch we authorized $7 billion of seller financing. That is right now in the process of taking off. We also permitted more of that $7 billion to be used for affordable housing. We also took an initiative to secure ties, mortgages, multi-family mortgages, one to four mortgages. That lone so far we have secured ties about $5 billion in mortgages for a net savings to the government to the cost of the bailout of $250 million.

We have encouraged RTC to use SANDA's in a very prudent and caution fashion, to make sure that we do not get into situations where property is being sold at a distressed price, that we are actually trying to ensure that we have the value inherent in that property.

We support the pricing policy that RTC has come up with. In fact, as you recall there is a new program called the Portfolio Sales Program. We have told RTC that they can function under that program up to the point they have sold $8 billion of book value. We have established that as a pilot program because we wanted to make sure that it works and it is the right thing to do.

Senator BREAUX. Let me make a point here. Our tax credit is $500 million each of 2 years. You testified between January and August your carrying charges alone are $420 million.

Mr. CHAISSON. That is correct.

Senator BREAUX. Now I would submit that those kind of numbers that you are paying just to hold the property that you are not selling of $420 million over an eight month period that are a $500 million tax credit in a year to move the property and to get it sold and to put it in people's hands that are going to use it to produce revenues, to make it a taxpaying piece of property to generate revenues is a pretty good deal.

I mean what you are doing is costing us $420 million and you are not getting rid of the property in 8 months. I am just suggesting putting aside a potential tax credit of $500 million and get the property sold. I mean your cost is almost as much as my cost, except you do it in 8 months.

Secretary GRAETZ. Well, Mr. Breaux, I think that the $420 million number is the holding costs for the entire $20 billion of real estate. I am not sure that the accurate comparison—that is, I do not know what your estimates are of how much of that real estate would be sold by the tax credit. There is a difficult choice that any owner of property, including the RTC, has in the current market where real estate prices seem to be lower than they will be in the future. That choice is a trade off between continuing to hold the property and incurring some holding costs and selling it sooner. It is a tough property-by-property question as to when you do that.

I think in fairness that the tax credit does not eliminate that problem. That problem will be there whether the choice of the RTC manager is to give a tax credit or to lower the price. I think that that choice and particular given some of the flexible programs in terms of packaging the property, I do not think that choice is going to be a different choice.

Mr. CHAISSON. Let me just add, Senator, that carrying costs, a lot of these properties are in very, very, very bad shape. We have issues where we have to clear title. That takes time. We have surveys that need to be done. That all takes time. That all costs money.

Senator BREAUX. Let me submit something. I am not replacing what you are doing under the current system; I am just giving you another tool to use. You can continue to lower prices and not move very much, if that is the preference. I am just saying you have another tool that you have the authority to use and what you are saying is, we refuse to look at anything else because we think this thing is working real well. We are just going to go back to Congress and get another $80 billion it is working so well.

I am going to suggest that when you come back to Congress there is going to be a lot of people unhappy with another $80 billion request. You can continue to lower the prices. I mean I think I am hearing you that we like what we are doing.

I am saying you can continue to do that but just have yet another option on the table that you also can pick as a tool to move the property.

Secretary GRAETZ. Our concern, Senator Breaux, is that the tool will increase the overall costs to the government, that there will be additional costs to taxpayers and their advisers of trying to evaluate, value an comply with these requirements. The IRS will be required to monitor compliance with the tax credits long after the property is sold by the RTC and those problems, those kinds of problems in at least our experience with other kinds of tax credits in this area have been serious ones.

Senator BREAUX. Let me ask you something about seller financing that you said you all have used. Have you gotten any of the property back under that?

Mr. CHAISSON. To the best of my knowledge, RTC has not gotten any property back.

Senator BREAUX. All of the seller financing that you all have done, do you think has been 100 percent successful?

Mr. CHAISSON. The program has just taken off right now. We have done approximately $300 million in seller financing so far.

Senator BREAUX. So it is too early to tell?

Mr. CHAISSON. Too early to tell, right. The portfolio sales program will also involve seller financing, too.

Senator BREAUX. I thank you all for coming. I mean obviously what I am trying to do—Maybe it is not obvious. It is obviously not obvious to the Treasury Department. One of the things I am trying to do is just to give you another tool, not to replace the ability to continue to lower the price and hopefully sell something, but just to give you another tool to experiment with and use to try and encourage new buyers to come in and make an investment which I think would end up saving all of us money instead of losing it.

We have some disagreements that are obvious and they are now part of the record. But I think it is important to have this discussion.

Secretary GRAETZ. Thank you, Senator.

Senator BREAUX. That you all.

Mr. CHAISSON. Thank you, Senator.

Senator BREAUX. Let me bring in Congressman Bill Orton. The House is back. From the State of Utah. I guess Tom Ridge from Pennsylvania is here. Congressman Ridge, we are delighted to have you.

We are pleased to have you back. Thank you.

STATEMENT OF HON. BILL ORTON, A U.S. REPRESENTATIVE FROM THE STATE OF UTAH

Representative ORTON. Thank you, Mr. Chairman. The House gives us an opportunity to remain physically fit as well as mentally aware as we are doing these things. I apologize for having to leave twice for a vote and hopefully we will not have another one immediately.

I would like to thank the Subcommittee for the opportunity of coming to express my personal views on the pending bill. I would like to personally commend you, Senator Breaux and Senator Kerry, for your thoughtful analysis for your well intentions in attempting to create a mechanism which will allow the RTC to move toward disposing of these properties.

It is unfortunate from my point of view that I cannot support this particular mechanism and it is because of my personal knowledge and background in my former life, before coming to Congress, I was a tax attorney. I have spent ten years working with the Internal Revenue Service and ten years in private practice in tax law working much of my time on real estate related tax issues.

I am not a one issue politician, but if there is a driving motivating factor which pushed me into political life it is this very issue. So I feel very strongly that, in fact I could not agree more with Senator Kerry's comments. What he said is exactly right. In fact, there is a very strong corollary connection between the tax changes that Congress saw fit to engage in in 1981, 1982, 1984, 1986 which during that time period took real estate values on a roller coaster by providing rapid escalation of value through advantages, rapid depreciation deductions, exemption from at risk rules, very, very beneficial rules for partnerships. All of these things provided a rapid escalation of value, a strong incentive for investors to put money into real estate. This driven real estate market opened up a vacuum for capital and the capital from savings and loans and banks and insurance companies and pension funds flowed into this area of investment creating the overbuilt, overpriced real estate market which we were sitting in the middle of in 1986 when we then yanked the bottom out from underneath every one of these incentives, causing such a rapid spiraling deflationary value of real estate that the savings and loans who were out far beyond what they should have been out on questionable loans started to collapse, sucking the rest of the savings and loans, now sucking in banks, insurance companies, pension funds.

We are dealing today with a problem in the Resolution Trust Corporation. We are dealing today with trying to find a way to sell this $20 billion of troubled real estate the RTC is holding and cannot sell for the last 8 months or a year.

That is the edge of the precipice of the pending gloom before us if in fact banks begin to collapse, and insurance companies begin to collapse, and pension funds begin to collapse, pulled down through this black hole which we in part have created because of the tax changes that we have enacted.

Now I commend this Subcommittee, and you personally, Senator Breaux, for recognizing the impact that a tax incentive or a tax change can have. I do not believe that this particular tax change is the appropriate mechanism. Because it is a narrow focus change, it is a targeted credit only on property that the RTC now holds.

In fact, if you look back over the history of incentives for real estate and tax incentives, if you have an across the board tax incentive the pressure on market value is an upward pressure. It is stabilizes, it increases the value of real estate in general. However, if you have a targeted benefit, a targeted credit, the impact is to increase the value or hold stable the value of the targeted item while driving down the value of nontargeted items.

Therefore, I think the former testimony is accurate that if in fact you have two identical parcels of property side-by-side both worth $1 million, one owned by the RTC and one held by Chase Manhattan Bank and both of them are trying to sell those pieces of property for $1 million the fact that you place an 80 percent tax credit on the RTC property and are able to sell that for $1 million is not going to mean that this property sitting next door to it is still worth $1 million. It is worth less because it does not have an 80 percent tax credit.

That is the sole problem that I have with this proposal, is it is too narrow.

Senator BREAUX. Let me ask you a question on that point, Bill.

Representative ORTON. Okay.

Senator BREAUX. Is it not the same thing happening when that million dollar piece of property that the RTC holds which is not being sold is constantly having their price reduced, reduced, reduced?

Representative ORTON. Absolutely, yes.

Senator BREAUX. So they eventually sell it at say 20 percent or 50 percent of what it is worth. Isn't the same affect on the next property?

Representative ORTON. Absolutely, yes. That is correct.

We have another vote coming. I will be very brief.

You are correct. It is the exact same problem when you continue driving down value. So what we have to do is we have to find a mechanism which will hold value, which will stabilize or perhaps even increase the value of the property. If we can find that, it will benefit not only the RTC property, it will benefit the properties held by banks, it will benefit the properties held by insurance companies, by pension funds, and in fact if we look and recognize the fact that part of this downward pressure has been created by the tax disincentive for owning real estate established in the 1986 Tax Code, Code Section 469 of the Internal Revenue Code, the Passive Loss Provisions, creates a disincentive to owning real estate. It is the only tax disincentive for any ownership and it is directed at real estate.

What we could and should do is attach to the resolution trust restructuring the funding. We should attach a mechanism which reverses that tax incentive. Put real estate on an equal par. There are two proposals. One in the House; one in the Senate right now—H.R. 1414—which would do that. It is having a difficult time getting out of the Ways and Means and the Senate Finance Committee. Let's attach it to the RTC bill. Let's get it out that way.

There are a couple of other things that could be done, overall, broad base that will support the value of real estate. Reinstitute capital gain treatment for real property. We could also create a financing mechanism, a seller financing mechanism. Which right now you pointed out we are paying out $420 million in 8 months to carry the property. We are paying people to hold and manage the property. Why not create seller financing right now? Sell it at a fire sale price with a carried interest of the Federal Government. So in the future when that property is sold a portion of the profits will come back to the Treasury Department.

Now you are not creating a disincentive, a destabilization of price, you are creating an incentive that will dispose of real property now and give profits back in the future. A share of those profits will come back to the Treasury Department. We could start using the private sector right now. Real estate agents, there are hundreds of thousands of real estate agents out there who could be listing and selling these properties right now instead of trying to do it all through the RTC.

There are a number of mechanisms we need to be looking at. I applaud your direction in considering tax incentives as one of them. I would encourage you in this direction. I just think that this one targeted approach is too narrow.

Senator BREAUX. I appreciate that. I am one of the supporters that Senator Boren has to the passive loss bill here. I am a co-sponsor of it. I think that is one of the things we ought to do.

[The prepared statement of Representative Orton appears in the appendix.]

Senator BREAUX. Let's get Tom in here.

STATEMENT OF HON. THOMAS J. RIDGE, A U.S. REPRESENTATIVE FROM THE STATE OF PENNSYLVANIA

Representative RIDGE. Thank you very much, Senator. I will ask unanimous consent that my entire statement be included as part of the record.

Senator BREAUX. Without objection.

[The prepared statement of Representative Ridge appears in the appendix.]

Representative RIDGE. I would share with my colleague with whom I serve on the Banking Committee that I agree in large measure with his concern about the action of Congress over the years it has taken the value out of real estate and certainly it is incumbent upon us to put it back.

But I think that is separate and apart from the initiative that you have undertaken in S. 1787. Congressman Frank from Massachusetts and I intend on offering a similar proposal when we have the RTC mark-up over on the House side.

What is very attractive to this, and I certainly disagree with my friends from the Treasury, absent any new initiatives from Treasury, other than we want more money, it is certainly incumbent with us to try to come up with some additional tools for them to get the job done.

Absent any initiatives from Treasury, we want more money, it certainly behooves us to explore every possibility. I think this is a very attractive possibility. Because you and I know that the traditional sources of equity are not out there, particularly for some of these properties that are illiquid. Unless we are very resourceful we are going to end up owning and managing these as they depreciate to zero value and no one can compute the ultimate affect of those losses other than that they will be substantial.

I think we need to find access to new investors. I think this is an approach that gives us access to new investors. I certainly think that this model approach will avoid much of the negative spillover that my colleague is concerned about in these neighborhoods. I disagree somewhat. I think you will have a stabilizing effect. This will be clearly $1 billion out of $80 billion is not going to dramatically reduce the value of real estate anywhere. It will be a transactional use of that tax credit to hopefully appropriately be used in areas where it can do not only the taxpayer but the investors the most good.

But so be it, $1 billion out of $80 billion is not going to have that major affect. I would like to think that through the use of this program and at least the consideration of this unique initiative that folks on this side, in your Chamber, and in our Chamber, will try to come up with even better ideas than simply going to the taxpayers and saying we need more money.

I mean it is pretty clear, Mr. Chairman, and you and I share the view that it would be a lot better off for as many private citizens investing in RTC real estate and making a few dollars or making a lot of dollars, than having the Federal Government, which means everybody that you and I represent end up holding the bill for this whole mess.

So I think you are to be commended by accessing more investors and by increasing the supply of equity. I think this tax credit will move more property at a higher price than existing methods of sale and I would certainly hope that your colleagues would agree and we will do all we can to see that it is inserted into the RTC bill over on the House side.

Senator BREAUX. I think something is going to happen. I mean I think that an awful lot of members are just going to be very hesitant just to vote for more money without some sign of something creative coming back other than just we need more money to run the shop. Maybe it is passive loss which I would enthusiastically support.

Representative RIDGE. Yes, we all do.

Senator BREAUX. Well we all do not. That is the problem.

Representative RIDGE. We have 300-plus co-sponsors over on the House if we could get them to move. I think as my colleague said, that restores some of the value for purposes of real estate investment. But that in and of itself is not enough. This was a very thoughtful, a very creative idea and I will see what we can do over on the House side.

Senator BREAUX. I appreciate very much you taking the time to cover over. I know the schedule has been crazy. But thank you very much. We appreciate it.

Representative RIDGE. Thank you, Senator.

Senator BREAUX. Let me welcome as our colleagues leave, Mr. Robert Reischauer, who is of course the Director of the Congressional Budget Office. Bob, we are glad to have you back and look forward to your testimony.

STATEMENT OF ROBERT D. REISCHAUER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE, WASHINGTON, DC

Mr. REISCHAUER. Senator Breaux, I appreciate the opportunity to appear before the Subcommittee to discuss CBO's analysis of S. 1787. With your permission I will submit my prepared statement for the record and will confine my remarks to a brief explanation of why CBO has concluded that offering tax credits to purchasers of RTC commercial property would increase, not decrease, the overall costs of resolving the savings and loan debacle.

It is unquestionably true that the sales prices of properties sold with a tax credit would be higher than would be the prices that could be obtained if the RTC lowered the price of the properties as it is doing now until they could be sold without the benefit of a tax credit. The reason for this is straightforward and simple.

Buyers would be willing to pay something for the tax benefit. The higher prices generated would increase receipts for the RTC when the properties were sold and Federal spending would decline. Because these receipts would be classified as offsetting collections.

While the RTC's books would look better as a result of these credit assisted transactions the Government's costs of resolution must also take into account the multi-year revenue loss that would be associated with the tax credits.

To determine whether the policy makes economic sense one must determine whether the increased receipts generated by the higher sales prices would be sufficient to offset the reduction in tax revenues that would be associated with the credit.

Under certain very extreme circumstances this might be true. For example, this would be the case if a potential buyer regarded a tax credit which had a present discounted value to the government of $1 as equivalent to a $1 reduction in the price of the property. If this equivalency held the Government would realize the same net receipts measured in present value terms whether the properties were sold with or without a tax credit.

In practice, however, potential buyers would not value a tax credit with a present value of $1 as equivalent to a $1 reduction in the price of the property for two reasons. The first of these is that the buyers are almost certain to face higher discount rates than the Federal Government does because they face higher costs for borrowing funds. The second reason why the buyers would demand the premium from the tax credit alternative is that the credit involves more risk than does a simple sale.

The added risk could be associated with several different things. First, the possibility that the buyer's income might change unexpectedly in a direction that could reduce the value of the credit to the buyer. Second, the possibility that tax laws might change as they have several times in the last decade. And third, the possibility that the buyer might have to sell the property before the full benefits of the nontransferable tax credit could be realized.

In addition, it is worth noting that the prices offered under the tax credit alternative could be lower than expected because the pool of potential buyers would be restricted to those who expect to have positive tax liabilities for the next 5 years. In other words, tax exempt non-profit institutions and corporations anticipating no or low tax liabilities would not join in the bidding.

The factors that I have just described lead to the unambiguous conclusion that it would be more costly for the Government to sell RTC properties using the tax credit than to sell them at a lower price without the credit. In other words, the present value of the revenue loss from the credits would exceed the present value of the increase in the RTC's receipts from higher sales prices.

If the tax credit option is going to cost the Government something one might ask whether it might generate some offsetting benefit. Unfortunately, from CBO's perspective there seems to be none. The proposed credit would not increase sales of RTC's property above the volumes that could be expected by the lower cost policy of reducing prices, nor would the credit act to prop up local commercial property values because the supply and therefore the underlying rental values of the properties would not be affected by the tax credit.

To conclude then, the tax credit proposal contained in S. 1787 could be expected to increase resolution costs of the savings and loan debacle on a present value basis without providing any apparent benefit.

That completes my statement and I will glad to answer any questions you might have.

Senator BREAUX. Well thank you for being with us.

[The prepared statement of Mr. Reischauer appears in the appendix.]

Senator BREAUX. Let me ask you just a general question. RTC has just told us that in 8 months it cost them $420 million in carrying charges to carry these properties they currently have. We have given them $80 billion and they are now coming back with another $80 billion, essentially using one methodology for disposing of the property.

Can you say that that is working?

Mr. REISCHAUER. Well it is certainly not working as well as all of us would like. But I think the representative from the RTC explained that this process is extremely complex, that the legal situation of a lot of these properties is complex and ambiguous, that the condition in which the properties are is not great, and that there is a lot of work that has to be done just to get these properties ready for sale.

That conclusion is invariant whether it is a simple sale or a sale with the benefit of a tax credit.

Senator BREAUX. But it also boils down to, does it not, the fact that they just do not have any buyers. I mean they can talk about there is a lot of difficulties in titles and everything else and I am sure that is part of it. But essentially, there is really nobody really running after these properties dying to buy them.

I mean isn't that one big factor as well, to try and increase the amount of interest that buyers have in this property?

Mr. REISCHAUER. Well the way we traditionally increase the interest in a good that is being sold is to lower the price. The price can be lowered either directly by charging a less high sticker price or you can leave the sticker price constant and add on a lot of green stamps or other goodies. I mean you can say you can buy this television set at the list price of $400 and I will throw in four toasters and an iron to go with it. That is basically what the tax credit alternative is.

Senator BREAUX. Well one of the basic differences is the fact that by continuing to lower the price are we not having an adverse affect on the surrounding properties. What have you thought about that?

Mr. REISCHAUER. No, I do not think we are really at all.

Senator BREAUX. Oh, I will tell you what, I have some folks in Louisiana that have been wiped out because of having unfortunate misluck of being located next to RTC properties. I mean who would love to hear the theory of why they did not have their property, you know, cut in half in terms of its value.

Mr. REISCHAUER. Well the reason the value of their property has been cut in half or lowered is that the supply of property far exceeds the demand. If we have, once again, two buildings right next door to each other that are identical in every respect, one owned by RTC, one owned by a private individual, and they are both put on the market. One would expect them both to receive the same price.

If the RTC property then were offered with a tax benefit associated with it, the sales price obviously would be higher for the RTC property than it would be for the other property. In no way would the sale price for the other property be changed. It would still be at the very low distressed price that existed before this tax credit were offered on.

Senator BREAUX. Yes, but at least it would be reduced.

Mr. REISCHAUER. No. I am suggesting that the prices might be well below the appraised price both for the RTC property and the private property without any tax credit situation. The real issue for a buyer of this property is, you know, what am I going to earn from rents off of this piece of property or the use of the property over the next few years and what is likely to happen to the appreciation of the property over the period that I want to hold it.

The appreciation is going to be determined by the overall supply and demand for property in that area. That is fixed by the amount of property in existence. The only way the RTC can help this situation, help the private individual, is to reduce the supply of property that is available—burn the building, tear the building that it owns down. But clearly that would be an extreme proposition.

Senator BREAUX. What does CBO tell Congress as far as a recommendation with regard to just putting more money in the current system? Is it ever going to end? I mean we had an estimate early on of what it was going to cost us, $40 billion or what was it?

Mr. REISCHAUER. That was never our estimate. We were well above any of the other estimates, although I admit we were still low.

Senator BREAUX. That is what I am saying. I mean there is going to be an awful lot of people out there when we have to look at another $80 billion who are just getting eaten alive by people back at our Congressional Districts that tell us we are looney tunes for listening to our advisors in Washington that tell us this is going to end.

I mean they say you are out of your tree, Senator, if you think I want another $80 billion to a system that is in place that is not working and you are giving them another $80 billion to continue doing essentially the same thing. Try something different when you are drowning. I mean throw them a life ring.

Mr. REISCHAUER. The question I think that is before you is a very difficult one for the average American to understand. That is the choice between, let's say, offering the RTC $80 billion more in funds to spend and offering it, say, $60 billion more. But at the same time reducing tax revenues that are likely to flow into the Treasury over the next 5 years by $30 billion. So the total cost to the Federal Government would be $90 billion as opposed to an explicit expenditure of $80 billion.

We are often too ready to agree to a reduction in the increase in the flow into the Treasury because it is in a sense less visible than an explicit appropriation of funds for a particular government service.

Senator BREAUX. Well I appreciate that. But what I am hearing from you and also from Treasury and RTC is, essentially do not do anything as far as changing what we are doing in the way of getting out. There is nobody coming up with any innovative ideas.

I am saying, hey, if it is not mine, give me something else. Because people back home are not buying it anymore. They are saying you all have been up there listening to people who do not make a lot of sense to us back home. And $80 billion and then $80 billion and then you are telling me it cost them $420 million to just keep the stuff for 8 months. Now you want to do it again.

I mean that is what we are hearing back home. Now we can come up with all kinds of Washington theories and charts and graphs. But I tell you what, politically, people are not buying it and I do not blame them. Because what we are saying right now is we are just going to come up and go to the Senate floor and the House and vote to spend another $80 billion which we do not have to continue doing the same thing.

Because I did not hear anything new, other than continuing to lower the price. And, man, that is not working. Am I correct in assuming you want more money for the same stuff?

Mr. REISCHAUER. I am not disagreeing with you that it is not working. The question is whether the alternative will work any better. I am suggesting that the alternative from the long run perspective of the American taxpayer will not.

Senator BREAUX. I agree with that point.

Mr. REISCHAUER. There is a simple resolution of this which is that you could say that the RTC would have to take into account the least cost resolution of this property to the Government, not to the RTC, but to the entire Federal Government and choose whichever mechanism involved the least cost to the Federal Government.

I would be fairly sure that there would be no take up on the tax credit. I could be wrong. There could be very peculiar kinds of circumstances which would show that this produced some change in behavior.

Senator BREAUX. Well that is one of the points which is well taken, that we do not know and we are never going to know, I would submit, unless we try.

I think a point here is that my suggest is not an alternative to replace the current system. It is just an additional tool that they have the authority to use in a limited fashion, controlled by RTC as to how much they have to allow the tax credit to be to encourage the sale of that piece of property. It may not be 80 percent. It may just be a very small tax credit.

It is not to replace the current system. It is just to say let's try a $1 billion program, $500 million in each of two years, which is going to be less in 1 year that they are paying to carry all this property. Let's just try it. If it does not work, back off and say, hey, it did not work, let's go back and try something else.

But right now I am hearing a stubborn attitude, not from you but from the people running the program, that they know how to do it. There is an awful lot of people that are saying, I do not think they do. The reasoning and the facts are, it is not working so, you know, let's try something else. But I am not trying to replace what we have now, just to give them another tool to try it.

If it works we all should go away happy; and if it does not, I would argue that we are not much worse off than we are right now.

Is your position or job to try and recommend some other ways of helping to do this or are you just——

Mr. REISCHAUER. Yes, fortunately we are in the position of not making recommendations, but only analyzing proposals that are put forward.

Senator BREAUX. I appreciate that. I appreciate your input, too. I am not blaming you for the RTC problems, obviously. I want to make that very clear.

I thank you very much.

Mr. REISCHAUER. Thank you.

Senator BREAUX. Let me welcome up John M. Urbanchuck, from Pennsylvania and have him present his testimony.

STATEMENT OF JOHN M. URBANCHUCK, PH.D., WEST CONSHOHOCKEN, PA

Mr. URBANCHUCK. Thank you, Mr. Chairman. My John Urbanchuck and I am a vice president with AUS Consultants which is a Philadelphia based economic and management consulting company. I am also the principal author of an economic analysis of the asset disposition and revitalization credit program that was prepared in September 1990. I would ask at this time that my written testimony and the study that we did about a year ago be included in the record.

Senator BREAUX. Without objection.

[The prepared statement of Mr. Urbanchuck appears in the appendix.]

Mr. URBANCHUCK. I am pleased to appear before the committee this afternoon to discuss the potential benefits of the asset disposition and revitalization credit or ADR credit as we call it for short. As we heard today the amount of property held by the RTC and FDIC continues to escalate as the economy languishes through an unprecedented sluggish recovery.

While the costs associated with acquiring property by the Government are escalating so too are the costs associated with carrying and maintaining property and inventory. It is important to note the government is not in the primary business of maintaining and operating property. The RTC and FDIC does not have the staff or capabilities to match a private sector management or manager with a market determined incentive.

Now as a result the value of these assets can be expected to decline as long as they remain in government hands. I would like to make a couple of points in response to testimony that we have heard earlier with regard to several aspects of the ADR credit. The first point I would like to make is in direct response to an argument Dr. Reischauer made in his testimony. And he cites the study I did last year about the ADR credit, in which he says the cost of holding property are avoidable by cutting the price.

I suggest that the Director did not consider the restrictions that are specifically in the law to restrict the RTC from cutting the prices of properties to a market clearing level in distressed areas. That is in the FIRREA legislation. We heard Treasury and RTC talk a little bit about the authority they had with regard to lowering prices and a recent decision that they could come down to 80 percent. If they go below that obviously they have to go back to the Board of Directors. It is not quite as easy as deciding just to cut the price.

It is important to note that these restrictions were put into the law specifically because Congress was worried about the surplus property being dumped onto the market. Both the RTC and the FDIC have been conducting auctions to sell off real estate holdings but potential investors have been slow to respond. What we feel is needed is an economic incentive to induce private investors to come forth and acquire this property.

We also feel the ADR credit is such a vehicle. Now tax credits were created by Congress to provide an incentive for investment and sectors of the economy deemed in the national interest. Examples include the Research and Development Credit enacted in 1981 to induce private sector investment and research and development and the low income housing credit created in 1986 to encourage the construction of low-income rental housing.

It is important to take a look and contrast the similarities and differences of these tax credits. The main difference between those two tax credits and the ADR tax credit, the ADR credit is not an entitlement; it is a fixed sum. We are talking about $1 billion. You know what the cost of it is going to be up front.

The main similarity of the ADR credit with the other credits is that they can be passed through to the ultimate investor in the property. The alternative of cutting the direct sales price of a property does not carry with it any distributional implications. As in the case of the low income housing credit experience with the program has demonstrated that the credit itself attacks investor interest in a way that the underlying value of the property itself would not.

One important feature of the ADR credit is that it would bring new money to the real estate sector. Bank financing, as we all know, is very hard to obtain today and particularly for these assets. The ADR credit would mobilize non-bank financing. In that sense essentially what it would do is shift the demand curve rather than force the investor consumer down the demand curve by just lowering the price.

The credit would focus investment capital on the market specifically on the kinds of assets that carry the credit. Now on a perfect credit or capital market all assets with the same degree of risk would have the same rate of return. The ADR credit gives the investor a higher after tax rate of return so the qualifying properties are more attractive with than without the credit.

The affect of all this on the price of the assets is exactly symmetrical. They should sell on a higher price based on the rental incomes they can produce. Given amount of rents paid will have a higher after tax value to the investor with than without the credit. We feel the ADR credit will also have important benefits by preventing additional deterioration of local real estate markets.

The property holdings we are talking about here are highly concentrated in economically depressed areas. As the RTC and FDIC lower the market or recorded transactions prices of distressed properties in an attempt to reach a market clearing price, the value of the surrounding real estate also tends to fall. It is not only under cuts all property values but further deteriorates the quality of portfolios of financial institutions. That is those financial institutions that are not in trouble now may find themselves in trouble because the value of their portfolios is deteriorating.

Importantly, it also undermines confidence of lenders, borrowers, investors and consumers. I would like to contend that one of the main problems in restraining the recovery right now is failing or flagging consumer confidence. Consumers, investors and other people are having problems with the level of confidence. What we need is something to improve that.

We feel the ADR's credit essentially results in reducing the market price of the property by the amount of the credit. But importantly it does not affect the recorded transactions price. As a result the value of the surrounding property, particularly if it is economically viable or performing, if you will, should not be affected as directly as a cut in the market value or the price of the property.

Now in his testimony Dr. Reischauer argues that the overall market values of the properties in the locality cannot be propped up by the existence of the ADR credit because the market values are determined by the capitalized values of after-tax rents. Because the ADR credit does not change the number of properties that are out there, he contends it cannot prop up the market values. But he does agree, however, that the price of the properties held by the RTC and the FDIC would be increased because investors would be bidding for the ADR credits.

Now essentially the price of non-affected or non-eligible properties you would contend that they would fall to the level of the RTC property and be discounted by the amount of the tax credit. If there were only two bidders in the market, you might expect that to be the case. But if you are talking about a competitive market I contend that you would have an increase in the value of the property for which the tax credit would be available because people would be bidding or essentially bidding for that tax credit.

Now there is an unfortunate confusion here between the idea of halting a continued decline in real estate values due to the pressure on the market from a large inventory of vacant real estate and the tightening of credit resources due to declining asset values.

Now I do not think anybody and certainly we are not arguing that the credit is a device to increase real estate values in general. Now on the contract the purpose of the credit would be only to increase the sales price of RTC and FDIC properties by attracting new financing from nonbank sources.

Indeed, on the very last page of his testimony Dr. Reischauer says, and I quote, "True sales of RTC property with a credit would be recorded at a high selling price." We just heard him say that a little while ago, too. I am sure that every bank and other institution that must rely on the reported selling price of real estate is either a direct measure of its value or an indirect measure as comparable properties recorded would see the result of the ADR credit as a very positive benefit.

Previous testimony also makes the case that the tax credit would be seen as a potential investor as inferior to a direct cut in the price of the property. That is, it is better to cut the price than it is to offer the tax credit. Because buyers would bear more risk with a tax credit from unexpected changes in income tax law.

I want to make two points with regard to this. First, in the case of low income housing tax credit, investors do not seem to treat the credit as a risky thing but as a government guarantee of some yield from the investment. Investors know what their income from other sources is expected to be and they evaluate the tax credit as something that enhances the after-tax value of that income. I do not think there is a genuine risk from the absence of taxable income in this analysis.

Secondly, the risk that Congress would repeal the tax credit may theoretically exist, but for a 2-year tax program I think that risk is quite small. Moreover, the other tax credits we are modeling the ADR credit after do not suffer from this position or perception in the market. I think CBO is concerned with a nonexistent problem today. It might have existed in 1986 and 1987 but I do not think so today.

Once granted the tax credit would become a right attached to the ownership of the property. Congress would not constitutionally be able to take away a specific credit although it could discontinue the credit in respect of future sales of RTC or FDIC property.

Previous testimony also indicated that buyers would require larger dollar amounts of credits than they would as direct price cuts. Now I would note that there has been a comparison of the government's borrowing costs with investor's borrowing costs.

Because the government's borrowing costs are theoretically lower they generally assign a greater present value to the option of holding the property in inventory, thence to selling it with a tax credit attached. I have two problems with that analysis.

First, we were criticized by our use of that particular alternative and essentially it has been contended that the true alternative is between cutting the price versus holding the property. Then CBO argues in favor of holding the property because the government can borrow at a cheaper rate than a private investor.

Well if lower interest rate on Treasury bonds is a determining factor in this equation then the answer appears to be easy. Congress should just let the RTC and FDIC keep its inventory of property and let the taxpayer simply pay interest on the bonds.

Our analysis of the credit is based on an idea that the government is a poor custodian of all this real estate. Putting it back into the private sector is the way to get the real economic value out of it. THe privatization is what we are telling the East Europeans and the Soviet Union to hurry up and do. Why should we not enact the same measures to do the same things in America with all this commercial real estate?

Now we took a look at the economic evaluation of a $1 billion credit over 2 years, $500 million a year, and looked at it in a present value situation. We have valued the alternative of giving an 80 percent tax credit, $500 million a year, for two years, 5-year tax credit, with the alternative of the government holding that inventory of property, having it devalue essentially by an economic depreciation rate factoring and maintenance and costs of holding that property.

Essentially the results of our analysis that is summarized in the study that we are introducing indicate that the tax credit provides essentially a $2 benefit of revenue or $2 of revenue for every dollar of tax credit extended. Now the important factor here is to keep in mind that we have tried to factor into the extent that we could the costs of holding and maintaining that particular property for a 5-year period of time or at least evaluated the alternative of holding versus selling that particular piece of property.

When you take a look at the extension of a billion dollar tax credit which guys $1.25 billion worth of property and contrast the cost of that to the Treasury in terms of foregoing tax revenue and then compare that against the alternative of holding that equivalent amount, depreciating it by 3 percent which is essentially what experience has showed us that property depreciates at, or at least the literature indicated, factor in costs of holding and maintaining that property, the tax credit seems to come out way far ahead of the alternative of holding it.

Clearly selling it as quickly as possible as close to the appraisal value is the best way to go with that. We contend that the ADR credit, because as I said it shifts the demand curve rather than forces someone to move down at a lower price, is a way to bring in the requisite funds that will help with that, that particular problem.

Now there are also economic implications that are important that will result from the use of the ADR credit and will essentially result from moving the property into the private hands as quickly as possible. Now as these properties are returned to the private sector and brought into the economic mainstream by private investors they will generate output, incomes and jobs.

This output and income will in turn generate additional tax revenue, both at the Federal and State treasuries and perhaps even more importantly in certain instances local tax revenue as well. These benefits will help offset the direct costs associated with the foregoing tax revenue experience by the Treasury that would be caused by the tax credit.

Now the question is, will the ADR credit work? Will it provide an adequate economic inducement to entice private investors to acquire property. Now we do know that RTC and FDIC efforts to cut prices on property have been at best marginally successful.

We also know that the tax credit programs have been successful in attracting private venture capital in the past. What we are suggesting here is a program, we are endorsing a program of $1 billion to try the program. If the AR credit turns out to be successful it can be readily expanded. If the credit does not work the cost to find out is relatively limited.

Now attached to my testimony I would like to submit for the record an analysis produced by Mr. Joe Cobb who is a former minority staff director of the Congressional Joint Economic Committee that evaluates in a theoretical sense the alternatives that we talked about, that is moving down the demand curve by cutting the price and shifting the demand curve and is essentially increasing the size of the market.

With that I conclude my comments. Thank you.

Senator BREAUX. Thank you very much. Obviously you know that I think highly of your assessment of what we are trying to do here. I think you made a good point. I think Dr. Reischauer had raised it or maybe Treasury about people worrying about whether Congress may change it. Well those who actually get it that would be an entitlement because it would be under the terms of the program within the limits of the program and that sale that has that tax credit, it would be guaranteed that tax credit over the life of the program.

Mr. URBANCHUCK. Yes, sir. That is right. The risk there is relatively small.

Senator BREAUX. There was almost no risk. I mean unless Congress comes out retroactive and then comes and takes it away from them which they are not going to do. It is only a 2-year program and so it is a limited test. So I think the changes of changing something within 24 months is obviously not very risky at all.

Mr. URBANCHUCK. There is another element of that, too, Senator. That is that the expenditures under the tax credit would only occur as it was used to acquire property. So that if for one reason or another it did not work there would be expenditure associated with that.

Senator BREAUX. What about the point you make that their argument is that we will just continue to lower the price until we sell it. That is the best way of doing it. Now you point out that Congress has passed a law pertaining to property in a di~tressed area that puts a floor on how much in fact they can lower that asking price below the assessed value. Isn't that correct?

Mr. URBANCHUCK. That is correct. That obviously was a very, very serious concern. Because in classic economic theory there is a market clearing price or a price at which the market will clear. What RTC and Treasury are suggesting is that we find that market clearing price.

Well that may be fine for a limited set of properties but as you indicated yourself there are corollary properties, properties that have positive economic value whose prices are also affected by that. The second part of that is also important. That is that financial institutions, in some cases, hold the mortgages on those properties and bank examiners which these days have become less than friendly fellows in most instances are looking very closely and very carefully at the value of those underlying properties.

I was privileged several years ago to testify before this committee during the farm financial crisis on exactly the topic that Senator Boren had talked about in his introductory comments. That is the implications of the spiraling downward fall in agricultural land prices and the impact that had on the farm financial community.

What we are looking at here in terms of a free fall or potential free fall in property values can have very, very serious secondary and tertiary impacts on other property.

Senator BREAUX. Could you explain to me briefly your statement and analysis that went into it that allows you to say that the ADR credit will generate almost $2 in revenue for the government for every $1 of tax credit extended?

Mr. URBANCHUCK. Yes, sir. I am going to find my notes.

Senator BREAUX. I am going to go out to the floor on the Senate and talk about that so that everybody can have an understanding of what I am trying to explain and the people out there will understand what we are talking about. How can I say that the tax credit will end up generating $2 for every $1 of tax credit.

Mr. URBANCHUCK. What we did is we took, as I indicated, $1 billion tax credit over a two year period at the time—$500 million at the first of 2 years and 80 percent tax credit would facilitate the sale of $1.25 billion of property. The present value of that at a 9-percent discount rate, and we used a 9 percent discount rate in that case, which was at the time we did the study the prevailing price of 25 to 30 year government bonds. An equivalent long-term market interest rate.

The present value of that is $1.1 billion. Now if you subtract the cost of the credit, the cost to extend the tax credit, which is $684 million that gives you a net positive value of $415 million. So you have a positive value there.

The alternative case was that if the RTC were to hold on to $1.25 billion worth of property, that is valued at $1.25 billion in year one, we depreciated it 3 percent a year and we factored in the costs of maintaining and carrying that, which we factored at 9 percent.

Now the numbers that were given out, we do not know what that is. I will be honest with you. We went through the literature. We talked to people. We relied on the building owners and management association estimates of carrying costs for equivalent commercial property or office buildings, that sort of thing. It is going to be very, very wide and diverse.

Their numbers indicated that the cost of maintenance as about 5 percent a year and the cost of insurance is about 4 percent a year. So we used the 9 percent estimate. It will be interesting to see if that—I forgot what the denominator of that was.

Senator BREAUX. It is $420 million in the first 8 months.

Mr. URBANCHUCK. The first 8 months on a value of $22 billion?

Senator BREAUX. $22 billion.

Mr. URBANCHUCK. That is less than 2 percent which to me seems low based on the estimates that I have seen in the industry. But that comes out of that particular industry. But the point of the matter is we used the 9 percent rate. We used 9 percent discount rate.

We assumed that the RTC would hold that property for 5 years and sell it at the end of that 5-year period of time. The revenue stream of that activity is $239 million. So what you are doing is you are comparing $415 million for the sale of the property in the first 2 years through the use of the tax credit, assuming that we bring additional investors in, we bring the additional capital in, $415 million on one hand with a revenue stream of $239 million by holding the property for a five-year period. Selling it at the end of 5 years I should say. That is roughly two to one. That is how we came up with that estimate.

Senator BREAUX. I appreciate the work and the study that has gone into this. I think that you have spelled it out in a very precise and clear manner that I think makes sense. I think it has to be understood that this is just a tool we are trying to give RTC. We are not trying to replace what they do. It is just an additional tool that they would have to utilize in helping us get out of this mess. Because I am just really concerned that if we just go back and say to our constituents that we are just going to spend another $80 billion to let them continue along the same lines that they have been doing in the past, that is not going to be accepted by the people out there unless there is some new changes. This is just one potential way of handling it.

So I thank you very much for your work and for your testimony.

Mr. URBANCHUCK. Thank you very much.

Senator BREAUX. Thank you.

Let me invite up now Mr. John Kyte who is vice president for legislative affairs with the New England Council out of Boston and Mr. Norm Flynn, immediate past president of the National Association of Realtors who is testifying also on behalf of the National Realty Committee, the National Association of Industrial and Office Parks, and International Council of Shopping Centers.

We are pleased to have you both here. Mr. Kyte, we will have you first. We are glad to have you here.

STATEMENT OF NICHOLAS P. KOSKORES, PRESIDENT, NEW ENGLAND COUNCIL, INC., BOSTON, MA, ACCOMPANIED BY JOHN P. MANNING, PRESIDENT, BOSTON CAPITAL PARTNERS, BOSTON, MA

Mr. KOSKORES. My name is Nick Koskores. I am president of the New England Council.

Senator BREAUX. All right.

Mr. KOSKORES. I have a joint statement to submit for the record on behalf of my self and Mr. Jack Manning.

Senator BREAUX. Okay.

[The prepared statement appears in the appendix.]

Mr. KOSKORES. Mr. Chairman, again thank you for the opportunity to appear before the Subcommittee today to present my views in support of S. 1787, the Acid Disposition and Revitalization Act of 1981.

Again, my name is Nick Koskores. I am president and CEO of the New England Council and I am accompanied here today by Mr. John P. Manning, President of Boston Capital Partners, Inc., and a valued member of my association.

The New England Council is the nation's oldest regional business group dedicated to improving the economic vitality and overall quality of life in our six State region. The New England Council supports S. 1787 introduced by yourself and co-sponsored by Massachusetts Senator, John Kerry.

The recession in New England began a year and a half before the national recession and has been much deeper. In an effort to combat our economic plight the public and private sectors have joined together to implement an ambitious program of economic renewal. Two significant problems could restrain and ultimately derail a recovery program.

The first is the credit crunch which despite comments to the contrary is real and is continuing to add to the economic chaos in New England. The second, a related problem, is the over supply of commercial real estate. New England, much like the southwest, is burdened by an excessive supply of commercial properties.

In addition, declining real estate values due to the depressed real estate market have resulted in a significant reduction in New England property values. This unfortunate situation drains our economy of jobs, tax revenues and overall wealth and places even more pressure on our fragile banking system and there are many small businesses dependent on our banks.

Up New England we call this kind of a thing a death spiral. One of the most important benefits of the Breaux/Kerry legislation is the stabilization of property values. S. 1787 would halt the downward slide of property values by establishing a floor for FDIC and RTC properties. Owners of private sector commercial properties would clearly benefit from this stabilization as would public sector agencies who must try to sell seized properties at the highest possible price.

Our second benefit of S. 1787 is that it will significantly reduce the oversupply of government owned property on the commercial market. The Federal Government is now the largest owner of commercial and residential real estate in the country. Economics have estimated that RTC and FDIC will eventually own more than $60 billion in real estate or approximately 1 percent of all private real estate in the United States.

This oversupply of government owned property has crowded out the sale of privately held property and has severely hampered the ability of the market to efficiently transfer this real estate back to the private sector. S. 1787 helps overcome this problem by providing an alternative source of equity funding that does not compete with the private sector for limited debt funding at financial institutions.

Finally, S. 1787 helps reduce taxpayer exposure. As you know, Mr. Chairman, Treasury Secretary Nicholas Brady, FDIC Chairman William Seidman, appeared before Congressional committees this summer requesting $80 billion in additional funding for the RTC. More recently the Congressional Budget Office and the GAO have testified that this additional funding will not be sufficient and that billions more in taxpayers' dollars will be needed to bail out the savings and loan industry.

We in New England are increasingly concerned about the billions of tax dollars authorized by Congress to fund a Resolution Trust

Corporation and the slow pace of acid sales to date. Mr. John P. Manning, President of Boston Capital Partners will present a more detailed review of the Breaux/Kerry legislation.

Senator BREAUX. Mr. Manning, do you have some additions?

Mr. MANNING. Yes, thank you, Senator.

Senator BREAUX. Thank you.

STATEMENT OF JOHN P. MANNING, PRESIDENT, BOSTON CAPITAL PARTNERS, BOSTON, MA

Mr. MANNING. Although the ITC has been modestly successful in paying off some depositors and in marketing its huge financial portfolio, real estate assets are selling at an extremely slow pace. In spite of a few well publicized sales the RTC has sold less than 5 percent of its entire portfolio of assets. Neither the taxpayer nor the real estate industry can continue to support this growing supply of government-owned real estate.

In spite of some of the opinions expressed by Washington-based groups here today, the overwhelming attitude among voters participating in focus groups which we conducted around the country revealed anger and frustration over the S&L debacle. Voters in Oklahoma, New Orleans, Houston, St. Louis and other cities understood that the S&L crisis has cost billions in hard-earned taxpayer dollars. It will cost billions more.

They are disturbed by the inability of our leaders to resolve the S&L crisis and are eager for new ideas which will resolve this problem quickly and at a reduced cost to the taxpayer. Unlike the Washington insiders who have gone to great lengths to criticize this proposal the average citizen and the potential investors have evidenced strong support for the credit as a means of reducing taxpayer exposure and maintaining local property values.

Respondents in both general population and realtor groups strongly prefer the tax credit idea to the alternative proposal of significantly lowering the price of distressed property. Some of the real estate industry argue that a return to passive losses will revive the industry and will result in greater sales of RTC and FDIC real property.

In this the industry is correct. Indeed, most bankers will respond that the elimination of passive losses in 1986 was the primary cause of the banking disaster that exists today. However, the perspective on Capitol Hill and outside the beltway is decidedly different from that of industry spokespersons. Most impartial observers of Washington think it is unlikely that the passive loss legislation will pass in the near future.

The revenue impact of such changes in the Tax Code will be expensive and Congress neither has the revenue nor the desire to divert limited funds to benefit wealthy real estate speculators.

In addition, the powerful Chairman of the House Ways and Means Committee, Congressman Rostenkowski, has repeatedly voice his criticism of these modifications and it is unlikely that legislation will be successful over his active opposition.

Finally, unless passive losses may be utilized by non-owner operators no new capital will flow to the commercial real estate sector. New capital is what is needed in the commercial real estate sector.

Clearly the industry must assume a more aggressive and more political sensitive view if it hopes to win favorable tax treatment from the Congress. One way this can be achieved is through support of the asset disposition revitalization cut at the ADR. If enacted, the ADR credit will decrease the hemorrhaging of taxpayer dollars spent on the S&L bailout while reducing the depressing effect on government-owned properties on the real estate market.

The ADR credit will be a limited program designed to expedite the sale of hard to sell RTC and FDIC properties. The credit which is based on the successful low income housing credit, more information of which I would like to have permission to submit to you later, Senator, will be a five-year credit based upon the acquisition price and the rehabilitation expenditures of a selected number of RTC and FDIC properties.

The proposal provides for a $50,000 exemption from the passive loss rules, as contrasted with the $25,000 exemption from low income housing. The emphasis should be here that rehabilitation will also provide revitalization of properties and properties will be returned to be coming active members of the economy. The ADR credit will (1) stabilize declining real estate values; it will (2) democratize the RTC and the FDIC sales process by permitting average investors and average taxpayers to participate through the securitization process; (3) it will save taxpayers an estimated $2 for every dollar used to finance the program; (4) it will guarantee the sale of RTC and FDIC property, as the credit can only be utilized after the sale of the RTC or FDIC property has occurred; and finally, (5) it will ensure that property sold by the RTC and the FDIC will not revert to the government if the project should again fail.

What the ADR credit will not do is it will not be available for properties that can be sold for market or near market prices. It will not be accessible to any officer, director or substantial shareholder of a failed S&L acquired by the RTC. Some individuals have argued that the credit is an inefficient way to stimulate the real estate industry.

These so-called classical economists believe that the market should not be influenced by the Tax Code and that eventually the law of supply and demand will "clear" the market of government-owned properties. While these individuals may be right on a conceptual basis they can predict neither the probable cost of the bailout nor the number of years the real estate industry will remain depressed due to the overabundance of RTC properties.

The tax credit mechanism has proved to be an effective tool in attracting investor dollars to low-income housing and should prove as efficient in clearing the market of RTC property. A more noteworthy argument suggests discrimination against nontaxed advantaged properties. While this contention has some merit it ignores the fact that the private commercial real estate has not sold and will not sell as long as an overabundance of government owned properties depress the market and reduce available credit and stifle all sales activity.

Obviously there can be no discrimination if local markets remain dormant. Despite the possibility of market discrimination once the ADR credit program is implemented the stabilization of property values in the resurgence of real estate markets will more than offset any incidental damage to some private commercial properties.

The ADR credit is designed to be a selective program with limited resources and with the objective of carefully stimulating local real estate markets while maintaining property values. By reducing the oversupply of government owned commercial properties and infusing new investor capital into these local markets the ADR credit will revitalize deteriorating real estate much like the historic rehabilitation credit has restored many of the nation's blighted urban areas.

Arguably, the ADR credit is not a panacea. We have never represented it to be such. Nevertheless it is a creative first step in the return of commercial properties to the private sector and in the revitalization of a health and prosperous real estate market.

I thank you, Senator Breaux, for your creative attempt to try and solve this problem and am ready to answer any questions.

Senator BREAUX. Thank you, Mr. Manning. Norm Flynn, welcome.

STATEMENT OF NORMAN D. FLYNN, IMMEDIATE PAST PRESIDENT, NATIONAL ASSOCIATION OF REALTORS, ALSO ON BEHALF OF NATIONAL REALTY COMMITTEE, NATIONAL ASSOCIATION OF INDUSTRIAL AND OFFICE PARKS, AND INTERNATIONAL COUNCIL OF SHOPPING CENTERS, MADISON, WI

Mr. FLYNN. Thank you, Mr. Chairman. My name is Norm Flynn. I am a realtor, also a commercial broker, developer, asset manager and owner of income-producing properties. So I am one of the people that work in the field on a day-to-day basis. I am the immediate past president of the National Association of Realtors and I am also representing six other additional groups here today. So the burden on me to represent the industry I think is broader.

I am representing an International Council of Shopping Centers with its 27,000 members who own and operate and control the majority of the retail centers in the United States; the National Association of Industry and Office Properties, which represents 5500 companies throughout the United States; the National Association of Realtors with its 800,000 members who are brokers, managers, appraisers and developers; the National Council of Community Bankers which are 350 insured institutions with 4,000 branches nationally; the National Housing Council which of the larger firms in the United States in the multi-family industry; the National Realty Committee, which is sometimes referred to as the real estate roundtable and some of the larger major developers throughout the United States; and lastly, the National Association of Home Builders which represent 155,000 member firms and some 8 million employees throughout the home and construction industry.

In all I am representing this afternoon in the paper that I have submitted and these comments approximately 1.4 million people that are directly involved in the real estate industry and business and in every phase of that business.

I think by way of background, Mr. Chairman, I would like to speak to two issues. One, the RTC and what is has been able to do in the past and then also the general condition of the industry.

We have heard in testimony from Senator Kerry and various other people this afternoon already many of the comments.

I believe that the RTC has had a tremendous and difficult task. I heard it characterized by Peter Monroe who is the president of the oversight board recently in reading a speech that he gave in Florida. That if 2 years ago you were made the CEO of a corporation the size of Citicorp and you had no staff, no policies, no offices, you were given the task of getting rid of all sorts of assets, all of which were negative in value, nearly negative in value, and you did it under the scrutiny of a fishbowl with all of the encumbrances that the Federal Government puts on top of you to make sure that you are doing it right and they are second guessing you all the way, they have had an enormous and difficult task.

I think over the 2 years while many people throw stones, I among them from time to time, I believe that they have made some progress and they are making better progress in recent months than they had in the preceding first year and a half. While that progress is painfully slow I am not so certain that that progress is much slower than the general market itself. And that when we look at the assets and properties that have been sold by the RTC and look what has happened in the conventional commercial market I think that you might see that they are painfully similar.

Because what is happening with the RTC properties is they are impacting the conventional market, and especially in States with high concentrations of these properties like your own State of Louisiana where there are high concentrations of these, the conventional commercial markets are all but dormant or latent.

And until something is done severely and importantly with the RTC properties to move them out of the government's hands into the private sector and as rapidly as possible, I think you will see this dysfunction within the conventional as well as the RTC market.

What about the commercial real estate market itself? We have already heard some testimony about the unwanted capital that came into the industry in the early 1980's. I sometimes refer to it as the tax candy act of 1981 which over stimulated the market with a candy which brought in additional capital and monies into the market. That is supplemented by foreign capital and institutions that were looking for ways to fight this intermediation and any savings and loans that put money in both loans and development projects, particularly in those parts of the markets in the 1980's that had any glimmer of hope for making a yield really overbuilt the market place.

Then the Federal Government in its infinite wisdom in 1986 passed the Tax Reform Act which took away the tax candy. And as we had surfaced as an industry on tax candy what they did was take not only the candy but all the food away. So there is an industry for the last 5 years that has literally starved itself to death. In the process it has been exacerbated by a credit crunch wherein a general observation of the industry that if you are in any income producing real estate at all that there is something devastating going on here.

The results of that, both tax candy and the shutting off not only of the candy are tapering back, but all food at all is a withering within the industry of the valuation of those properties where our studies show a loss in value of between 8 and 18 percent and other studies that will indicate a loss of value of up to 30 percent of the assets because of the removal of the Tax Act of 1986.

And as a result of that, what you have referred to as $160 billion problem in the RTC a financial community and a financial resources community throughout New England and the rest of the country which is devastating condition, a banking industry which is now even more questionable and an insurance industry as well.

So there have been devastating impacts because of these on the industry itself. And as a result, in my judgment, there is an equity paralysis within the commercial investment real estate business. Not just RTC properties but the entire industry that it is not just the RTC properties that are not moving, there are no properties that are selling. The only realizations that the Federal Government are getting right now by way of taxes from commercial investment properties are fundamentally from foreclosures. Those are foreclosures that occur and there is phantom income and because of it there is a tax event that create bankruptcy situations for almost all the owners that are forced into those bankruptcy foreclosure activities.

The only sales that are going are fire sales and they are fire sales at the very bottom of the market. So I compliment and commend you, Senator, for coming forward with an innovative approach to try to resolve the problem. Unfortunately, I do not think this approach is the one which best resolves the issue.

In looking specifically at Senate Bill 1787, I do not believe it is the answer and we have submitted a paper with I think some detailed analysis as to why those are not the answers. And fundamentally we feel it does discriminate between the private and the RTC sector. It will make the RTC sector a conduit to bring other properties through it so they may be incentivized. It will disadvantage the FDIC and other commercial banking institutions that have other real estate owned that will be competition with the RTC properties and eventually we will have to extend that credit to all of these institutions so they can survive free of the crippling of the conventional market and therefore disadvantaging it.

Senator BREAUX. Let me interrupt you on that point. The bill is intended to cover not just RTC properties but also FDIC properties. I do not think the way it came out in the drafting that that was included. But it will include it and she was supposed to include it initially. So RTC and FDIC properties would be treated the same.

Mr. FLYNN. Well, that will elevate a portion of that problem. I think you will still have the problem with the convention institutions that have other real estate owned that will be competition with the FDIC and may force some of those institutions in the FDIC liquidation and conservatorships so that they can in fact get the credits as well.

I would like in an analogy, almost like a person who has a heart condition and their left arm goes numb, and so we start shooting the left arm up with cortisone trying to make the arm better when in fact we ought to be looking at the heart of the individual. I believe that the real resolution of the problem of the RTC and the real estate industry in general is broader based.

Frankly, Senator, your name is on one of the bills that I think is the answer far more readily available and far more practical than the one that is before us this afternoon and that is Senate Bill 1257, the passive loss bill with Boren, Breaux and Symms as cosponsors, along with 34 other Senators. We believe that if passive loss for material participants were to be reinstituted into the law and made a way that that would go a long way towards resolving some of the problems of the RTC, that it will keep people into properties now that are walking away from those properties and turning them back to the RTC and institutions because out-of-pocket tax cash dollars cannot be written off against the out-of-pocket cash.

And in time people just stop putting cash in and say take your properties back. I give up. I can no longer put active hard cash dollars into a property that I can only passively write off and I have no passive income because the properties are not producing them.

I think it will keep professionals in the business, material participants, full-time active in the business and not necessarily the passive investors that will come to a tax credit program. Those will be limited partners who in the higher income brackets will look to a general partner. I have been general partner many times over and understand how that works.

But in fact passive loss for active material participants were to be passed it would keep the pros in the business and those are the ones really that have to asset manage this overbuilding so that we can manipulate and make it work within the system itself.

I think it would bring dollars into properties that badly and desperately need them. Why would you put hard cash into a transaction you cannot write the cash off from? With the passive loss constraints that are part of the 1986 Tax Reform Act you currently cannot do that. So with that removed by passage of passive loss we can get it done.

I think it would establish fairness in the Code because the 1986 Tax Reform Bill was called the equitable and fairness code. It is inherently unfair that someone who is in the business of owning and operating investment real estate cannot actively write off which they actively spend.

I guess lastly, if you look at the Mortgage Bankers Association's recent study when they looked at what would happen to the value of income producing real estate passive laws if passive loss were to pass they would indicate that values would increase 3 to 7 percent.

Now I have heard several figures today about how much property is in the RTC right now. I heard $22-plus billion dollars of commercial income producing properties. Petum & Roe suggests there is $49 billion of real estate and near real estate. Those are nonperforming loans of substantial amounts. So it is roughly $50 billion.

If, in fact, you get a 3 to 7 percent increase in the government owned properties alone you are talking about almost $3.5 billion from the government properties alone. If passive loss were to pass that would more than pay for passive loss over a full five-year period. So I strongly encourage the Congress and you, Senator, as a leading figure in this matter and someone looking for an innovative way to solve this problem to get the passive loss which has 310 sponsors in the House and 37 sponsors in the Senate. Some vehicle that that can be placed into the law to help resolve this.

You couple this with a capital gains treatment in real estate and I think you have a longer term solution to bringing back the entire market. If you bring these two features back I believe that the RTC properties will begin moving as well. If you are looking, and I heard you most of the afternoon asking for other innovations as to how we are going to move these properties that we cannot simply go back to the taxpayer year in and year out asking for $50 billion or $80 billion or $100 billion to continue the bailout.

I believe an increased seller financing component would go a long way towards resolving and in fact increasing the marketability of properties. Right now, frankly, there is no capital available in the market place for healthy properties. If you had to refinance any quality office building that is even full today it would be difficult to find lenders that would come to your table to make a loan in good locations that are relatively full. There are absolutely no lenders that will come to poor locations that are not full and in fact by definition the bulk of the real estate the RTC has are cats and dogs. Because if they could have been liquidated they would have been done so far earlier in the game.

So since the insurance companies are not in the game anymore and the commercial banks are not in the game anymore and the savings and loans are not in the game there is no credit for these properties. If, in fact, the RTC were to expand the seller takeback program and in fact advertise the seller take back program and make it assumable in the second and third tier of sale of these properties and do it at below market rates but above the Treasury bond rate so that the government would not loose money but make money, if they would then in turn take that paper and manage the paper which the Federal Government is quite good at doing, they could realize from that paper hard assets instead of coming back to the Congress for money could receive it out of the asset base.

In the big picture I believe the Federal Government's track record in dealing with hard assets, real property, is abysmal at best and absolutely horrendous at worse. There is not one single arm of the Federal Government that handles real estate well. Many arms of the government that handles paper well. If you could convert that real estate to paper through seller takeback financing, which is what we as an industry advanced almost a year ago and which is now done on an experimental basis, and if you were take that paper and use a junior/senior subordinated mechanism where you securitize the paper, the Federal Government's risk in that paper could be reduced to 10 percent of its value.

Wouldn't you, Senator, vote for a $10 billion outlay if you could remove $50 billion worth of real estate out of the RTC today? That is about what the risk would be if you did a full seller takeback financing mechanism.

On balance again, I compliment you, Mr. Chairman, for the innovation and concern about RTC properties and the commercial investment real estate business in balance and in large. I do believe it is going to take innovation. I do believe it is going to take some patience. I believe that if we pass a passive loss bill and get that done as quickly as possible, if we get a capital gains treatment back into the program where the equity which has been paralyzed within the industry is open and freed that RTC properties will again begin to move.

If we are innovative in seller takeback financing and we streamline some of the mechanisms that also will go a long way to resolve the problem. I, too, will stand for questions at your pleasure.

[The prepared statement of Mr. Flynn appears in the appendix.]

Senator BREAUX. I thank the panel for their comments, their suggestions, as well as the observations on the legislation. Obviously, I agree with Mr. Manning and Mr. Koskores' points that you made. I agree also with Mr. Flynn's comments on passive loss and capital gains. I introduced the capital gains tax reduction bill on the floor of the Senate today with a safety net in case it does not generate new revenues which I think it in effect will. But if it does not we have a safety net that takes care of it by creating a fourth top tax rate of 36 percent on those individuals with net taxable incomes of over a half a million dollars.

It is only two-tenths of 1 percent of the country and if it works they will not get touched either. Listening to the large number of people we are speaking for, Mr. Flynn, I thought that maybe if we assess each one of them just $1, I could raise enough money to pay for the entire program. You said you had 1.3 billion. Was that the number?

Mr. FLYNN. It is million, no. It is million people.

Senator BREAUX. Oh, I am sorry. I was wondering where we got the billion from. But anyway it is a large number.

Mr. FLYNN. When you are in Washington that "B" sticks out there very easily.

Senator BREAUX. Yes. It is that $80 billion request that I am concerned about and it is coming down the pike.

I mean, are we not having the same affect that I heard some of those that opposed this point when they say that the press is the price of the property by offering a tax credit. Isn't that happening now by just lowering the price every time every month that they lower it? I mean aren't we having an adverse affect on other real estate located in the same surrounding areas?

Mr. FLYNN. Absolutely we are. In fact, any real estate where there are high concentrations of RTC property simply are not selling because the average investor, even the sophisticated investor does not know where the bottom of the market is. And until these properties are sold and a mechanism is put in place to get them sold that will always be the case.

Even in the experimental program that you are talking about, Senator, unless you are able to remove all RTC properties with $1 billion in credit and if we have $49 billion worth of assets we are talking about 2 percent of the assets out there, that is not going to resolve that problem either.

Senator BREAUX. Well hopefully it would be a test program that if it worked we could increase it. And if it does not work we would eliminate it and not continue it. The idea and the reason why it is small is because we do not know what the results are going to be. I am just so concerned that they do not seem to be trying anything very creative. I just am real concerned.

How would you want me to vote if RTC comes to Congress and says, give us another $80 billion. We are going to continue doing the same thing.

Mr. FLYNN. We have traditionally after examining what the RTC have done in the past have supported those requests because we are very concerned, as you must be, and we must all be in this country and the financial stability of our banking and financial institutions. And if the credibility of the guarantee of the Federal Government with all savings institutions goes south then we have lost it all.

I, with you, would like to see more efficiency. I, with you, would like to see better productivity. I believe that if you do some expanded seller takeback financing that the cost to the Federal Government would be de minimis and the advantages would be substantial. They have been reluctant to run that program and as you have asked in earlier questions and earlier witnesses, what sort of losses would you be experiencing from that.

I would suggest to you that right now the Federal Government is holding these properties that are deteriorating as we speak. That if they can get it into the private sector's hands by taking back even 100 percent financing, and I am not suggesting that, but I am suggesting a highly leveraged financing, and put it in the hands of a professional that will manage it and put more cash into the project.

The worse case scenario that the Federal Government will get that property back some day and there will be default on the paper they have. But they will have had a yield in the paper while they are there. Frankly, you can sell that paper on Wall Street and let someone else take the risk of foreclosure if you take in the tranche what is called the BPs, and that is the risk of the 10 or 15 percent of the paper.

Senator BREAUX. Mr. Manning or Mr. Koskores, you have heard Mr. Flynn speaking on behalf of all the people who are really in the real estate business. You have home builders and the realtors and shopping centers representatives. I mean he is speaking for everybody who is in the real estate business and none of them think it is a good idea.

Mr. MANNING. Well actually as I listened to him I did not feel we were all that far apart. I am in the real estate business also and I totally agree with him on passive losses and capital gains and really everything. I think your legislation provides an additional tool.

I think our only point is that, and Mr. Flynn mentions that about seller financing for example, as being their methods. Seller financing definitely has a role in the overall process of liquidating RTC and FDIC property.

But what about the so-called hard to sell or highly distressed properties that yield very little in the way of income? How are you going to sell that paper? Moreover, have we not learned from the 1980s after binging on debt that we need more equity than we need debt, especially with heavily distressed properties?

I see your bill, Senator, as a compliment to what you have already signed on as a co-sponsor and what obviously Mr. Flynn's constituency wants. I think we all agree that what they want is the right thing to do for the real estate sector. Yours is a compliment to what they have already proposed.

Senator BREAUX. Mr. Koskores, do you have a comment?

Mr. KOSKORES. Yes, Mr. Chairman. Speaking for a broad-based business group in New England through review of our credit availability task force we look at your legislation as something eminently doable. We were attracted very much by its targeted aspect. In New England with the FDIC pretty much ruling our banks up there with all of our five New Hampshire banks going down the tubes we are horiffic pressure. That is the business community is under horiffic pressure finding liquidity, finding the wearwithal to continue their business operations and your proposal has the attraction of again being quite doable.

I do commend efforts to restore passive losses and capital gains treatment. This is one other ace in that hand.

Senator BREAUX. Well I appreciate your comments, your suggestions. I think, I mean, we have the same goals I would say to Mr. Flynn. That is to try to get the property moved. Like you pointed out, Mr. Manning, it is a question of how we do it.

I am concerned that if we wait until we get passive loss legislation passed they will have grass in the lobbies of these buildings. And while it is a noble goal I enthusiastically support it. I am a co-sponsor of Senator Boren's bill. I have introduced my own capital gains legislation. I am just frightened to death of continued $80 billion requests while we work on something that may or may never occur.

At least this is a pilot targeted program of limited amount. It would at least give us a chance to see if it works. And if it does not let's pull back. But if it does we may have an idea that can work. But anyway, your comments are well taken and I appreciate your help and assistance in being with us.

Thank you very much.

Mr. FLYNN. Thank you very much, Senator.

Senator BREAUX. With this panel, that will finish our panel of witnesses today. We thank everybody who was here with us. The committee stands adjourned.

[Whereupon, the hearing was adjourned at 5:07 p.m.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED

[SUBMITTED BY SENATOR DAVID L. BOREN]

DESCRIPTION OF S. 1787 (ASSET DISPOSITION AND REVITALIZATION CREDIT ACT OF 1991)

[Prepared by the Staff of the JOINT COMMITTEE ON TAXATION, October 21, 1991, JCX-23-91]

INTRODUCTION

The Subcommittee on Taxation of the Senate Committee on Finance has scheduled a public hearing on S. 1787 ("Asset Disposition and Revitalization Credit Act of 1991") on October 22, 1991. The bill was introduced on October 1, 1991, by Senator Breaux (along with Senator Kerry) and is intended to encourage the sale of real property held by the Resolution Trust Corporation by amending the Internal Revenue Code to allow a general business credit against the income tax of purchasers of such property. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the present-law rules pertaining to certain tax credits and the provisions of S. 1787 and an analysis of certain economic effects of the bill.

Part I of the document is a summary of the pamphlet and provides certain background information. Part II is a description of certain present-law rules relating to tax credits. Part III is a detailed description of S. 1787. Part IV is an analysis of certain issues raised by the bill.

I. SUMMARY AND BACKGROUND

Overview

On October 1, 1991, Senator Breaux, along with Senator Kerry, introduced S. 1787, entitled the "Asset Disposition and Revitalization Credit Act of 1991." The bill is intended to encourage the sale of real property held by the Resolution Trust Corporation (RTC) by amending the Internal Revenue Code to allow a general business credit against the income tax of purchasers of such property (the "RTC property credit"). Certain provisions of the proposed RTC property credit are similar to provisions of the present-law low-income housing tax credit.

Brief description of the bill

In general, the bill provides an aggregate of $1 billion of tax credits that the RTC may allocate to taxpayers in order to facilitate the disposition of real property in 1992 and 1993. The credits generally would be spread in equal installments over a 5-year period beginning with the year of the acquisition of qualified property. Under the bill, the RTC must allocate the lowest amount of credit to a property as is necessary to sell such property at the lowest price acceptable to the RTC. In no event may the present value of credits attributable to any acquisition of property exceed 80 percent of the purchase price of the property plus estimated rehabilitation and completion costs.

The bill also provides other special rules and limitations with respect to the credit. For example, the credit would be unavailable to certain persons previously associated with a failed depository institution or who had had an interest in the property. The present value of the credit could not exceed the taxpayer's equity investment

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of S. 1787 (Asset Disposition and Revitalization Credit Act of 1991)* (JCX-23-91), October 21, 1991.

in the property. In addition, the amount of the allowable credit is reduced if the taxpayer receives a Federally-funded grant with respect to the property. Upon the disposition of credit-eligible property, twenty percent of the gain would be paid to the RTC and would be excluded from the gross income of the taxpayer. A portion of the credit would be recaptured if certain estimated rehabilitation and completion costs of the property are not incurred.

The bill makes the RTC property credit a component of the general business credit, but provides more liberal limitations on the utilization of the RTC property credit than are provided for the general business credit under present law. In addition, the bill provides an exception from the passive loss rules for a certain amount of the credit.

Background information

As of July 31, 1991, the RTC had control over 166 institutions in conservatorship and 467 institutions in receivership. Conservatorship institutions under RTC control had gross assets of $73.1 billion of which $7.2 billion was real estate. Receivership institutions under RTC control had gross assets of $82.5 billion of which $12.1 billion was real estate.[2]

Summary of analysis of the bill

The proposed RTC property credit to some degree would increase the saleability of RTC assets and increase RTC receipts. However, it is unlikely that this would result in a net gain in Government receipts, and any benefits of the proposal could probably be more efficiently achieved through non-tax provisions. This is the case because acquirors of RTC property generally would not value tax benefits more than cash. In addition, the proposed RTC property credit may result in an inefficient allocation of capital.

II. PRESENT LAW

General business credit

Taxpayers are allowed to offset all or a portion of their tax liabilities with certain tax credits, including the general business credit. The components of the general business credit are (1) the investment credit,[3] (2) the targeted jobs credit, (3) the alcohol fuels credit, (4) the research credit, (5) the low-income housing credit, (6) the enhanced oil recovery credit, and (7) in the case of an eligible small business, the disabled access credit.[4] The general business credit generally may not reduce a taxpayer's net income tax liability below the greater of (1) the taxpayer's tentative minimum tax liability for the year, or (2) 25 percent of so much of the taxpayer's regular tax liability that exceeds $25,000. The portion of the general business credit not utilized in a taxable year generally may be carried back 3 years and carried forward 15 years.

There are no tax credits or other special provisions in the Internal Revenue Code (Code) relating-to the acquisition of property from the RTC.

The low-income housing tax credit

A tax credit is allowed in annual installments over 10 years for qualifying low-income rental housing, which may be newly constructed or substantially rehabilitated residential rental property. For most newly constructed and rehabilitated housing placed in service after 1987, the credit percentages are adjusted monthly to maintain a present value of the credit of 70 percent of the total qualified expenditures. In the case of newly constructed or rehabilitated housing receiving other Federal subsidies (including tax-exempt bonds), monthly adjustments are made to maintain a 30-percent present value of the credit.

A residential rental project qualifies for the low-income housing credit only if (1) 20 percent or more of the aggregate residential rental units are occupied by individuals with incomes of 50 percent or less of area median income, as adjusted for family size, or (2) 40 percent or more of the aggregate residential rental units in the project are occupied by individuals with incomes of 60 percent or less of area median income, as adjusted for family size. Credit eligibility also depends on the existence

[2] Testimony of L William Seidman, Chairman, Resolution Trust Corporation, Before the Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the Committee on Banking, Finance, and Urban Affairs, House of Representatives, September 12, 1991.

[3] The investment credit generally was repealed by the Tax Reform Act of 1986. The investment credit is still available for certain rehabilitation expenditures, certain reforestation expenditures, and the acquisition of certain energy property.

[4] The research credit, the low-income housing credit, the targeted jobs credit, and the energy property portion of the investment tax credit are scheduled to expire after December 31, 1991.

of a 30-year extended low-income use agreement for the property. If property on which a low-income housing credit is claimed ceases to qualify as low-income rental housing or is disposed of before the end of an initial 15-year credit compliance period, a portion of the credit is recaptured. The 30-year extended use agreement creates a State law right to enforce low-income use for an additional 15 years after the initial 15-year compliance period.

In order for a building to be a qualified low-income building, the building owner generally must receive a credit allocation from the appropriate credit authority. An exception is provided for property which is substantially financed with the proceeds of tax-exempt bonds subject to the State's private-activity bond volume limitation. The low-income housing credit is allocated by State or local government authorities subject to an annual ceiling for each State. The annual credit ceiling for any State is $1.25 per resident per year.

The passive loss rules of Code section 469 limit losses and credits derived from passive trade or business activities of the taxpayer. Such losses and credits generally may not be applied against income (or tax attributable to income) such as wages, portfolio income, or business income that is not derived from a passive activity. A special rule, however, allows individual taxpayers to utilize the deduction-equivalent amount of up to $25,000 of low-income housing credits in any taxable year.

III. DESCRIPTION OF S. 1787

General determination of the amount of the credit

The bill would add an "RTC property credit" as a component of the general business credit. The amount of the allowable RTC property credit would be equal to the applicable percentage of the qualified basis of each qualified RTC property held by the taxpayer at any time during the taxable year. The credit generally would be determined for the taxable year the property is acquired by the taxpayer from the RTC and each of the four succeeding taxable years.

For purposes of determining the amount of the RTC property credit, the "applicable percentage" would mean a percentage determined by the Secretary of the Treasury that would yield, over a 5-year period, amounts of credit that have a present value equal to not more than 80 percent of the qualified basis of the property acquired by the taxpayer from the RTC. The percentage would be determined for the month during which the property was acquired pursuant to rules similar to those of Code section 42(b)(2)(C) of present law.[5] The term "qualified basis" would mean the sum of (1) the unadjusted basis[6] of the property that is attributable to its acquisition by the taxpayer from the RTC, plus (2) the estimated cost to the taxpayer of rehabilitating or completing the property or project, if necessary. These estimated costs must be determined by agreement between the taxpayer and the RTC.

"Qualified RTC property" means any real property that is acquired by the taxpayer from the RTC in connection with the disposition or liquidation of the assets of a depository institution.[7] In addition, in order for a property to be qualified, the RTC must certify that (1) after making reasonable efforts, it is unable to sell the property at a price permitted by law without offering the RTC property credit, and (2) deferring the sale of the property is not likely to result in a sufficiently higher sale price to fully compensate the RTC for the estimated additional costs resulting from the deferral of the sale.

Certain limitations on the amount of credit

In addition to the computational and certification provisions described above, the bill provides other limitations on the amount of credit allocable to a property.

First, the amount of credit with respect to any qualified RTC property for any taxable year could not exceed the amount the RTC allocates to such property before

[5] Section 42(b)(2)(C) provides that, for purposes of the low-income housing credit, present value is determined: (1) as of the last day of the first year off the period over which the credit is allowed; (2) by using a discount rate equal to 72 percent of the average of the annual Federal mid-term and long-term rates applicable under section 1274(d) (1) of the Code for the applicable month; and (3) by assuming the allowable credit is received on the last day of the year.

[6] For this purpose, the "unadjusted basis" would be determined without taking into account the reductions to basis provided by section 1016(a) (2) and (3) of the Code for depreciation, amortization, and depletion allowances. A similar definition applies for purposes of the present-law low-income- housing credit.

[7] It is understood that the term "qualified RTC property" is intended to include any real property acquired by the taxpayer from a depository institution under RTC receivership or conservatorship.

its sale. The aggregate amount of credit that the RTC may allocate to all properties may not exceed $1 billion.

Second, the applicable-percentage used in determining the credit may not exceed the percentage specified by the RTC for the property that produces the lowest amount of credit necessary to sell the property at the lowest price acceptable by the RTC. The RTC would make this determination after taking into account all other benefits, regardless of source, provided in connection with the purchase of the property.

Third, the present value of the credit allowable to a taxpayer with respect to a property may not exceed the taxpayer's equity in the property. Such equity would be measured by the excess of (1) the taxpayer's cost of acquiring the property from the RTC over (2) the amount of any loan made by the RTC (reduced by the amount of any other property pledged by the taxpayer for such loan).

Additional special rules

In addition to the above potential limitations on the amount of credit allowable, the bill provides additional special rules.

The qualified basis of a qualified RTC property would be reduced by the portion of any grant -made with respect to the property that is Federally funded. The reduction in qualified basis would apply for the year the grant is made and all subsequent years.

The credit would not be allowed to any taxpayer who at any time (1) was an officer, director, or substantial shareholder in any depository institution the assets of which were acquired by the RTC or (2) held a substantial ownership interest in the assets acquired by the RTC. For this purpose, a "substantial shareholder" would mean any person who directly (or indirectly through attribution) owns 5 percent or more of the stock of a depository institution. A "substantial ownership interest" would be any interest that entitles the holder to 5 percent or more of the net income or gain with respect to the property. Property held by a partnership, trust, or estate generally would be treated as owned proportionally by its partners or beneficiaries. However, any interest as a general partner would constitute a substantial ownership interest.

If the qualified basis of a property is determined with reference to estimated rehabilitation or completion costs and such costs are not incurred by the end of the second year following the year of the acquisition of the property, the qualified basis of the property would be reduced by the amount of the estimated costs not incurred. In addition, the taxpayer would increase its tax liability by the excess of the amount of credit allowed for the preceding taxable year over the amount that would have been allowed using the recomputed unadjusted basis.[8] The basis adjustment and recapture rules may be applied with respect to any property by using any later date specified by the RTC.

Under the bill, Code section 1274 would not apply to any loan made by the RTC. Under present law, section 1274 generally provides that the issue price of a debt instrument that is issued as consideration for property and that does not have adequate stated interest is determined by discounting the payments due under the instrument by the applicable Federal rate. The payments due under the instrument are then recharacterized and treated as either principal or interest under the present-law original issue discount rules.[9]

The amount of credit allowed to a taxpayer in year the property is acquired or disposed of would be determined by multiplying the full amount of credit otherwise allowable for the year by a fraction, the numerator of which is the number of full months the taxpayer held the property during the year and the denominator of which is 12. The amount of any reduction of the otherwise allowable credit applica-

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[8] It appears that the taxpayer would not be required to recapture any credit applicable to the year the property was acquired.

[9] The application of this special rule in the context of the bill is unclear. In a limited sense, it may be intended to provide that if the RTC seller-finances the sale of a property to a taxpayer, the taxpayer's basis of the property for purposes of determining the amount of credit allowable would be determined with respect to the face amount of the loan (assuming the taxpayer pledges other property for the repayment of the RTC loan). This would have the effect of the taxpayer receiving tax credits for a portion of amounts that would otherwise be characterized as interest (as opposed to principal) under the original issue discount rules of present law. In a broader and more literal sense, the special rule may be intended to provide that the original issue discount rules of the Code do not apply for purposes of any RTC loan, regardless of whether the loan is made in connection with a sale of a property eligible for the RTC property credit.

ble to the year of the acquisition of the property would be taken into account in the fifth year thereafter.[10]

Treatment of subsequent dispositions of qualified RTC property

If any qualified RTC property is sold, exchanged, or otherwise disposed of by the taxpayer during the taxable year, the taxpayer would pay an amount equal to 20 percent of the gain to the RTC. For this purpose, the amount of gain would be the difference between (1) the amount realized (in the case of a sale, exchange or involuntary conversion) or the fair market value of the property (in the case of any other disposition), and (2) the unadjusted basis of the property (reduced by the expenses paid or incurred in connection with the disposition.) The Secretary of the Treasury would be authorized to prescribe regulations for the treatment of transactions described in the nonrecognition provisions of the Code. The amount of gain to be paid to the RTC would not be includable in the gross income of the taxpayer.

Any payment required to be made to the RTC under this provision may be enforceable by lien or other measures deemed appropriate by the RTC. The payment requirement would not be construed as giving the RTC or the United States any ownership interest in the RTC credit property as long as the required payment is made.

Coordination of the RTC property credit with other provisions of the Code

The RTC property credit would be made part of the general business credit. However, no portion of an unused general business credit that is attributable to the RTC property credit may be carried back to a taxable year ending before the enactment of RTC property credit.

For a subchapter C corporation, the present-law tax liability limitations applicable to the utilization of general business credit would be separately applied to the taxpayer's general business credit (determined by not including the RTC property credit) and the RTC property credit. This separate application of the limitation would potentially allow a C corporation to utilize a greater amount of total credits than if the RTC property credit were combined with the other general business credits for limitation purposes. For taxpayers other than C corporations, the RTC property credit may reduce up to 50 percent of the taxpayer's net chapter 1 tax for the year. A taxpayer's "net chapter 1 tax" would be defined as the sum of the taxpayer's regular and alternative minimum tax liability reduced by credit allowed against such liability (other than the credit allowed by Code section 34 an the RTC property credit).

The bill provides an exception from the passive activity rules of Code section 469 for up to $50,000 of RTC property credit for a taxpayer for any taxable year.

Effective dates

The RTC property credit provisions would apply to taxable years ending after December 31, 1991, with respect to property purchased from the RTC (1) after December 31, 1991 and before January 1, 1994, or (2) after December 31, 1993, if pursuant to a binding contract in effect on December 31, 1993.

IV. ANALYSIS OF ISSUES

Incentive for new capital formation and for the sale of existing assets

The RTC property credit has two parts: (1) a credit for expenditures for the rehabilitation and completion of property and projects purchased from the RTC and (2) a credit for purchase of RTC property. Besides potentially increasing the salability of existing assets, the first part of the RTC credit might be viewed as an incentive for capital formation since it provides tax credits for investment in the form of expenditures on rehabilitation and completion.

The second part of the RTC property credit is intended to be an incentive to help the RTC sell existing assets. To the extent the RTC property credit applies to existing assets, it should be distinguished from other business credits which are intended to promote capital formation. Except for one component of the low income housing credit (which requires substantial rehabilitation of existing assets), tax credits under present law generally do not apply to expenditures for purchase of existing

[10] It is unclear whether the taxpayer must still hold the property in this sixth year in order to claim this residual amount of credit.

assets.[11] In addition, the repealed investment tax credit generally did not apply to the purchase of existing assets.

Since the RTC property credit may be considered, in part, a credit to increase expenditures on new capital, it may be useful to evaluate the evidence on other credits intended to increase capital expenditures. In general, there is considerable-uncertainty about the effectiveness of tax credits for increasing investment. Proponents of business credits argue that they are necessary to maintain or to increase the level of those types of capital expenditures that qualify for the credits. Critics argue that, in general, taxes have limited impact on business and financial decisions and that these credits in particular are merely rewarding activities which would have occurred otherwise. Furthermore, if there is-any-increase in qualifying expenditure, it is at-the expense of reductions in other type of similar expenditures not qualified for tax credits.[12] The empirical evidence on the effectiveness of business tax credits is inconclusive.[13]

Factors determining the net impact on Government receipts

The credit for the purchase of existing RTC property is intended to increase sales of RTC property. Because a purchaser of RTC property receives a tax credit the effective price of the RTC property is reduced.[14] For example, assume a property held by the RTC has a fair market value of 20 without a tax credit. With the availability of a tax credit with a present value of 80, under certain conditions, the RTC might be able to raise the sale price to 100. However, the additional 80 of Government receipts from the sale of RTC property is offset by the 80 reduction in tax revenue. Therefore, in this best case, the effect of this tax provision on Government receipts is zero, and the property is sold for the net price of 20, regardless of whether the credit is provided.

However, it may be that the RTC is not selling property because it has set prices too high. In the above example, assume the RTC attempts to sell the same property for the price of 100 because this is its appraised value. However, the RTC would not be able to sell the property because its true value is 20. With a tax credit equal in present value to 80 percent of the purchase price, the RTC might be able to sell this property for 100. Although the Government in this case receives 100 for the property, and pays out 80 in credits, the Government also has also disposed of 20

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[11] For example, tax credits for are currently available for capital expenditures on new capital in the form of low-income housing, disabled access, rehabilitation of certain structures, acquisition of certain energy property, and certain reforestation expenses.

[12] For example, it has been argued that any increases in expenditures for qualified capital equipment attributable to the investment tax credit were primarily the result of substitution from structures (generally not qualified for the credit) to equipment.

[13] There has been substantial empirical work undertaken to assess the effectiveness of the investment tax credit. The results are inconclusive. For example, see Dale W. Jorgenson, "Econometric Studies of Investment Behavior: A Survey," *Journal of Economic Literature,* Vol. 9, December 1971 and Robert Eisner, "Econometric Studies of Investment Behavior: A Comment," *Economic Inquiry,* Vol. 12, 1974, pp. 91–103. Relative to the amount of research on the effectiveness of the investment tax credit, there is only a small amount of research on the effectiveness of other tax credits. Although some studies discuss their effectiveness, few provide econometric evidence. With regard to the research tax credit and energy tax credits, the little evidence there is suggests that they do not increase incentives. See, for example, Robert Eisner, Steven Albert, and Martin A. Sullivan, "The New Incremental Tax Credit for R&D: Incentive or Disincentive?" *National Tax Journal,* Vol. 37, No. 2, June 1984; and U.S. General Accounting Office, "Additional Petroleum Production Tax Incentives are of Questionable Merit" (GAO/GGD–90–75), Washington D.C., July 1990. Similarly, there is some evidence that the targeted jobs credit has had little effect on increasing employment. See, Linda LeGrande, "The Targeted Jobs Tax Credit, 1978–1987," Congressional Research Service, Report for Congress (87–616 E), July 14, 1987; Robert Tannenwald, "Are Wage and Training Subsidies Cost Effective? Some Evidence from the New Jobs Tax Credit," *New England Economic Review,* September/October 1982, pp. 25–34; and John H. Bishop and Suk Kang, "Applying for Entitlements: Employers and the Targeted Jobs Tax Credit," Center for Advanced Human Resource Studies, Cornell University, Working Paper #88–04, February 9, 1988. For discussions of the low-income housing credit and the rehabilitation tax credit, respectively, see, for example, ICF Incorporated, "Evaluation of the Low-Income Housing Credit—Final Report," U.S. Department of Housing and Urban Development, Office of Policy Development and Research, February 1991; and Betsy Chittenden, "Tax Incentives for Rehabilitating Historic Buildings: Fiscal Year 1988 Analysis," U.S. Department of the Interior, National Park Service, November, 1988.

[14] This description of the RTC property credit in this paragraph assumes that the RTC will set prices low enough to sell its property. There is at least one report that this is the RTC's practice. See Paulette Thomas, "Resolution Trust Corporation Makes Some Headway in Selling S&L Assets," *Wall Street Journal,* October 3, 1991. If, however, the RTC does not reduce prices sufficiently to sell properties (as described in the following paragraph), the efficiency of the credit may be equivalently evaluated in terms of cost of the credit relative to price reductions. The discussion below suggests that in order for a tax credit to be as effective as a price reduction of 80 the credit must have a present value of greater than 80.

of property. Thus, there is no effect on the government's net worth. Furthermore, without any amendment to the Internal Revenue Code, the RTC also would be able to achieve at least as favorable an outcome by selling the property without a tax credit for a price of 20.[15] discussed below, a tax credit will generally be less attractive to investors than a price reduction of equal value. Therefore, tax credits generally will be more costly to the Government than price reductions providing the same benefit to investors.

Effects of the RTC property credit on the sales price of RTC property

Proponents of the RTC property credit may argue that the credit would increase net Federal Government receipts because revenue lost from the tax credit would be offset by higher prices received by the RTC upon the sale of qualified properties. Although it is correct (as discussed above) that there is likely to be some offset, it is implausible that these offsetting receipts would be sufficient to result in a net positive impact on the budget deficit. On the contrary, as described below, it is likely that the credit will result in a reduction in Federal Government receipts.

It is possible for any price subsidy to increase price by the full present value of that subsidy. However, this would require the entire amount of the benefit of the subsidy to flow to the seller. This is likely when there is a fixed supply of assets eligible for the credit and a large number of potential buyers.[16] The relatively inelastic supply of RTC real property suggests that the benefit of the RTC property credit may accrue largely to the RTC in the form of higher prices.

However, it could be the case that, for reasons not associated with maximizing profit or because of financing constraints, the RTC may be anxious to sell some properties quickly once a certain minimum sales price is realized. Furthermore, because the real estate market is "highly heterogeneous, there may not be large demand for any particular property sold by the RTC. In this case, the RTC is not in as strong a bargaining position, and may not be able to capture the full value of the credit. As a result, the prices of the RTC property will not rise by as much as the value of the credit, and the net impact on Government receipts will be negative.

Other factors limiting price increases

The passage above argues that because buyers have some market power, it may be possible that the price of RTC property would not rise by the full amount of the credit, and that buyers may be able to capture some benefit of the credit. In addition, there are several other factors that reduce the attractiveness of the credit and may drive the value of the credit to purchasers below its cost. First, because there are some costs in applying for the credit and complying with rules pertaining to the credit, a purchaser may value these benefits at less than their cost to the Government. Second, the taxpayer may discount these benefits because of uncertainty about future changes in law which may diminish the benefits of the credit,[17] or because of uncertainty as to whether income tax liability to which the credit may be applied will exist in future years, or because there is some probability that a purchaser will have to sell the property and not receive the credit. For example, suppose because of a variety of factors, a buyer expected that only one half of the allowable credits of 100 would ever be utilized, and suppose that this turns out to be correct. Although the expected value to potential buyers is 50, and' the cost to the government is 50, potential buyers may be willing to accept the risk associated with tax benefits only with some discount for the uncertainty. Therefore, taxpayers might, for example, only pay 45 for tax benefits with an expected present value of 50.

Administrative cost of the credit

In addition to reduced tax receipts, the net effect on government receipts may be adversely affected by the increased costs incurred by the Internal Revenue Service and the RTC to administer this credit.

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[15] Although the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 restricted the ability of the RTC to reduce price of purchased assets substantially below their appraised values, these restrictions have been relaxed recently. Price reductions by the RTC equal to the amount of credit could largely achieve the same effect on sales as availability of a tax credit.

[16] In economics terminology, the division of the benefit of a tax credit (or of the burden of a tax) is referred to as the "incidence" of the benefit (or tax). The incidence of a tax effect, in a partial equilibrium analysis, depends on the relative size (in absolute value) of the elasticities of supply and of demand. If, for example, supply is totally inelastic and demand is infinitely elastic, the benefit of a tax credit will accrue entirely to the seller who may raise the price by the entire value of the credit.

[17] For example, the individual alternative minimum tax might be modified to include the proposed credit as a preference item.

Distortions in the allocation of capital

The RTC property credit may distort the allocation of capital by providing tax incentives that favor real property sold by the RTC over other real property. For example, suppose a business was deciding between two sites for the location of a warehouse. One site, owned by a private investor, might be superior from the perspective of the prospective purchaser to a second site, owned by the RTC, because the former is located closer to suppliers and customers. However, if the business were able to capture some of the tax benefits associated with the RTC property, the business might select an RTC property with the less advantageous location because of the availability of tax benefits.

Capital also may be misallocated because the tax credit may have different values to different prospective purchasers. Returning to the previous example, two competing businesses may be considering the purchase of a warehouse owned by the RTC. The first business is part of a consolidated group with large tax liabilities which is considering entering a new line of business. The second business is a start-up firm which, because of large capital expenditures and gradual market development, has no prospect of positive income tax liabilities for many years. Even if this start-up business were more efficient and could make better use of the property, the property might be purchased by the consolidated group since tax credits provide the start-up business with a relatively smaller benefit.

United States General Accounting Office

GAO

Briefing Report to Congressional Requesters

November 1991

RESOLUTION TRUST CORPORATION

Proposed Tax Credit Would Add to Government's Cost of Selling RTC Assets

GAO/GGD-92-14BR

GAO

United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-246398.1

November 1, 1991

The Honorable Donald W. Riegle, Jr.
Chairman, Committee on Banking, Housing
and Urban Affairs

The Honorable Jake Garn
Ranking Minority Member
Committee on Banking, Housing
and Urban Affairs

The Honorable John Breaux
United States Senate

This briefing report responds to your March 25, 1991, request that we review whether a tax credit would facilitate the sale of distressed property held by the Resolution Trust Corporation (RTC). Specifically, you asked us to evaluate the cost effectiveness of a tax credit program that would begin on January 1, 1992, and have a cap of $1 billion. You also asked us to discuss RTC's strategies to dispose of properties by lowering their prices and using other available alternatives.

The tax credit would be earned in 5 equal annual installments, and it would have a present value of up to 80 percent of the purchase price plus the cost of necessary rehabilitation of the applicable RTC property. Other specific characteristics of the tax credit proposal are listed in appendix I.

BACKGROUND

RTC was established on August 9, 1989, under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). RTC's overall mission is to resolve the problems of institutions previously insured by the Federal Savings and Loan Insurance Corporation and placed into conservatorship or receivership between January 1, 1989, and August 9, 1992. As of June 30, 1991, RTC had 193 depository institutions in conservatorship with gross assets having a book value of $89 billion. Also under RTC's jurisdiction were 430 receiverships with $71 billion in assets.

RESULTS IN BRIEF

We found that the Federal government would lose about $127 million on a present value basis with the proposed $1 billion tax credit program. Although the tax credit would increase sales revenue to RTC, these gains would be exceeded by the lost revenues to the Treasury. This result was obtained by comparing the proposed tax credit with RTC's current policy of obtaining sales by pricing real estate assets according to market values.

A private study of the tax credit proposal arrived at a different conclusion. This study concluded that the proposed RTC tax credit would have a benefit-to-cost ratio for the federal government of almost 2 to 1 when compared to the alternative of holding property in inventory for 5 years for eventual sale. This alternative, however, is not a realistic basis on which to analyze the tax credit because RTC's current policy is to sell properties soon after acquisition by setting price to market value.

RTC has several programs in place to dispose of its real estate properties. These include reducing prices to reflect current market values and providing seller financing. We are still reviewing the performance of these programs. In March 1991, RTC approved a new guideline giving its officials more flexibility in setting prices for properties to reflect market values.

Overall, we do not believe that this tax credit proposal is a cost-effective way for RTC to dispose of its commercial real estate assets. However, if Congress decides to enact this program, we suggest several changes be made to the original proposal to help minimize the losses. Two changes need to be made to align the RTC credit with the low income housing tax credit to avoid distortions in investor choices: the tax credit should be reduced from 80 percent to 30 percent of the present value of the purchase price and the number of years to claim the tax credit should be increased from 5 years to 10 years. Other changes would need to be made to protect RTC's financial interest. The tax credit proposal should provide for full recapture of the tax credits and penalties if RTC forecloses properties previously sold with tax credits attached to them. The proposal should also limit the fees that the syndicators would be able to receive from the sale of tax credit participations to private investors.

OBJECTIVES, SCOPE, AND METHODOLOGY

Our objectives were to

-- determine the net fiscal impact of the tax credit proposal described in your letter,

-- describe strategies used by RTC to dispose of properties by lowering their prices and using other available alternatives, and

-- discuss ways to improve the tax credit proposal.

To address these objectives, we used present value analysis to measure the benefits and costs of the tax credit program that would occur over 5 years. In addition, we interviewed various private sector representatives and consultants knowledgeable of the real estate industry, including an official of the private firm that prepared an economic analysis of the tax credit proposal. We also interviewed an RTC official responsible for sales of real estate assets, and we examined RTC data and RTC directives on real estate assets sales. We did not assess the reliability of RTC data because of time constraints. We reviewed previous congressional testimonies of RTC officials as well as GAO reports and testimonies on RTC.

We did our work in Washington, D.C., between June 1991 and September 1991 in accordance with generally accepted government auditing standards.

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We discussed the contents of this report with an RTC official responsible for real estate operations, who generally agreed with the analysis and information provided. His views have been incorporated into this report where appropriate.

We are sending copies of the report to the Secretary of the Treasury, the Chairman of the Federal Deposit Insurance Corporation, the Chairman of the Oversight Board of the Resolution Trust Corporation, the Executive Director of the Resolution Trust Corporation, the Director of the Office of Thrift Supervision, the Director of the Office of Management and Budget, and other interested parties. We will also make copies available to others upon request.

B-246398.1

The major contributors to this report are listed in appendix II. If you have any questions, please contact me at (202) 272-7904.

Paul L. Posner

Paul L. Posner
Associate Director, Tax Policy
and Administration Issues

C O N T E N T S

ABBREVIATIONS

AMT	Alternative Minimum Tax
FDIC	Federal Deposit Insurance Corporation
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act of 1989
RTC	Resolution Trust Corporation

THE RTC TAX CREDIT PROPOSAL:
DESCRIPTION, ANALYSIS, AND SUGGESTIONS

Characteristics of the RTC Tax Credit Proposal

- January 1, 1992 start.
- $1 billion cap.
- 80 percent present value maximum of purchase.
- Credits provided in five annual installments.
- Many other characteristics.

CHARACTERISTICS OF THE RTC TAX CREDIT PROPOSAL

We were asked to evaluate the feasibility of a Resolution Trust Corporation (RTC) and Federal Deposit Insurance Corporation (FDIC) tax credit with the following characteristics: (1) it would begin on January 1, 1992, (2) it would not apply to property purchased from RTC or FDIC after December 31, 1993, unless pursuant to an earlier binding contract, (3) the credit program would have a $1 billion cap on tax credits during the 2-year period, (4) the tax credit would have a present value of up to 80 percent of the purchase price plus the cost of necessary rehabilitation and completion for the acquisition of RTC and FDIC property, (5) the amount of the credit would be determined by RTC or FDIC and could not exceed the amount determined to be necessary to sell the property and could not exceed the amount of capital contributed by the purchaser of the property, (6) the credit period would be for 5 years beginning with the taxable year in which the property is purchased and would be earned in 5 equal installments, (7) any capital raised from investors using this credit would be paid directly to RTC and FDIC, (8) the credits from this program could be used to offset the lesser of $50,000 or 50 percent of the tax liability on non-passive income for individuals, (9) for corporations, the credit would be subject to the rules of the general business credit, including the maximum amount of income tax liability that may be reduced by a general business credit for any year, (10) the credit would not be considered as a preference item under the Alternative Minimum Tax (AMT) and could be used to offset tax due and owed under an AMT calculation subject to the limitations described above, (11) upon the sale of the property, 20 percent of any profits would be paid directly back to RTC and FDIC with the remaining profits being taxed at the appropriate capital gains rate, (12) ownership of property purchased by a private taxpayer under the credit must be maintained for 5 years in order for the taxpayer to continue to receive the credit, and (13) sale or refinancing of property before the end of the credit period would not trigger recapture but would cause any future tax benefits to cease.

Objectives

- To examine the net fiscal impact of the tax credit proposal.

- To describe RTC's strategies for disposing of properties without using tax incentives.

- To suggest improvements to the tax credit proposal.

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OBJECTIVES

We were asked to examine the net fiscal impact of the tax credit proposal. We were also asked to describe strategies employed by RTC and FDIC to dispose of properties without tax incentives including lowering the price of the property and other available alternatives. In addition, we were asked for suggestions on how the tax credit proposal could be made more effective.

Methodology

- Present value analysis.
- Interviews with private sector representatives and consultants and with RTC official.

METHODOLOGY

We used present value analysis to measure the benefits and costs of the tax credit program over 5 years. Present value analysis is used to measure the net impact of programs whose benefits and costs would occur over different time periods.

In addition, we interviewed various private sector representatives and consultants knowledgeable of the real estate industry, including an official of the private firm that prepared an economic analysis of the tax credit proposal.

We also interviewed an RTC management official responsible for the sales of real estate assets, and we examined RTC data and directives on real estate asset sales. We did not assess the reliability of RTC data because of time constraints.

We reviewed previous congressional testimonies of RTC officials as well as GAO reports and testimonies on RTC.

Fiscal Impact of the Tax Credit

Net RTC gain minus Treasury loss in net present value terms.

Treasury loss estimate exceeds net RTC gain by $127 million.

Transaction costs will decrease RTC gain.

FISCAL IMPACT OF THE TAX CREDIT

Most analysts would agree that the RTC tax credit would affect the federal government chiefly in two ways: (1) the U.S. Treasury would lose tax revenues over the 5 years that investors claim tax credits,[1] and (2) RTC would gain additional sales revenue from higher prices due to the tax credit.

Comparing these two effects over time using present value analysis, we estimated that the Federal government would lose $127 million due to the RTC tax credit program. We subtracted the present value of the Treasury tax revenue losses from the present value of the net additional revenues that RTC would obtain through the sale of tax-advantaged properties.

The Treasury's loss will exceed RTC's net gain because Treasury's discount rate is lower than private investors' discount rate, and positive transaction costs involved with the marketing of tax credits would reduce RTC's net sales revenues. The size of the loss will vary with changes in discount rates and transaction costs.

We did not include savings in holding costs as a benefit of the tax credit proposal because we concluded that the relevant alternative to the tax credit is lowering the price of RTC real estate assets to achieve quicker sales.

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[1]Due to time constraints, we did not include in the analysis estimates of (1) the administrative costs of the tax credit program, or (2) the tax revenue losses that would occur because purchasers of subsidized RTC properties would be entitled to offset depreciation expenses against ordinary income with respect to the entire purchase price of the properties.

Fiscal Impact of the Tax Credit

Table I.1: Estimates of the Present Value of Treasury's Tax Revenue Losses Due to the RTC Tax Credit (Dollars in millions)

Year	Nominal value	U.S. Treasury's discount rate 7%	8%	9%
1	-$200	-$187	-$185	-$184
2	-$200	-$175	-$171	-$168
3	-$200	-$163	-$159	-$154
4	-$200	-$153	-$147	-$142
5	-$200	-$143	-$136	-$130
Present value		-$820	-$799	-$778

Note: Sum of annual amounts may not be equal to present value due to rounding.

TREASURY'S TAX REVENUE LOSSES

We estimated the present value of the tax revenue losses to the Treasury by discounting them by an appropriate government discount rate that reflects Treasury's borrowing costs. We discounted the 5 annual $200 million tax revenue losses by a discount rate of 8 percent. Then we added the 5 annual discounted values to obtain the total present value of the $1 billion in tax revenue losses. The present value of Treasury's tax revenue losses is about $799 million if the applicable discount rate is 8 percent.

GAO's policy is that the government's discount rate should be the interest rate for marketable Treasury debt with maturity comparable to the program being evaluated, which in this case would be 5 years.[2] We assumed that the government's discount rate would be 8 percent, which is close to the 8.37 percent annual average rate for 5-year Treasury notes in 1990. GAO's policy is also to use a sensitivity analysis to address issues of different interest rates and opportunity costs faced by private investors. We also estimated Treasury's tax revenue losses using a 7-percent and a 9-percent discount rate.

As shown in Table I.1, if the discount rate decreases to 7 percent, the present value of Treasury's tax revenue losses increases to $820 million. If the government's discount rate increases to 9 percent, the present value of the tax revenue losses will decrease to $778 million.

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[2]Discount Rate Policy (GAO/OCE-17.1.1, May 1991).

Fiscal Impact of the Tax Credit

RTC's gain--investors' valuation of the tax credits.

- $721 million additional sales revenue for RTC properties assuming 12-percent investors' discount rate.
- Transaction costs reduce RTC gain by $49 million.

RTC'S GAIN DEPENDS UPON INVESTORS' VALUATION OF TAX CREDITS AND TRANSACTION COSTS

RTC properties with a $1 billion tax credit attached to them should have a higher value to private investors than similar properties without the tax advantage. The $1 billion in tax credits, which would be distributed in 5 equal annual installments of $200 million, represents 80 percent of $1.25 billion worth of properties that investors would have to purchase from RTC. The additional amount in sales revenues that RTC would obtain from attaching $1 billion worth of tax credits to its real estate assets would depend on the investors' discount rates and transactions costs.

Investors' Discount Rate

The additional amount that investors would be willing to pay to RTC for tax-advantaged properties depends on their discount rate. The discount rate compensates investors for deferring consumption spending and for bearing risks. The discount rate includes a risk premium that compensates investors for the likelihood of future negative events, such as (1) new legislation restricting the use of tax credits, (2) sale of tax-advantaged properties within 5 years of the purchase date, and (3) lack of taxable income to fully use the tax credit in any given year.

In order to find an appropriate discount rate for investors, we reviewed interest rate statistics published by the Federal Reserve Board, examined the real estate investment literature, and interviewed real estate consultants about the appropriate discount rate applicable to tax-advantaged real estate investments. We found that a 12-percent discount rate is an appropriate rate to be used in valuing private real estate investments involving tax credits.

If investors have a discount rate of 12 percent, the present value of the $1 billion tax credit to the investors will be about $721 million. Thus, investors would be willing to pay $721 million more for RTC properties with a $1 billion tax credit attached to them than for the same properties without the credit.

As with our analysis of Treasury's revenue losses, we did a sensitivity analysis to determine how these results would change if investors had different discount rates. Investors' discount rates are higher than Treasury's, reflecting private investors' higher borrowing costs. Accordingly, the present value of the revenues lost to the Treasury will exceed the present value of the tax credit and RTC's gains. RTC's gains would be further eroded due to transaction costs.

Fiscal Impact of the Tax Credit

Table I.2: Present Value of Tax Credits to Investors, Transactions Costs, and RTC Proceeds From Tax Credit Program (Dollars in millions)

		Investors' discount rate		
Year	Nominal value	10%	12%	15%
1	$200	$182	$179	$174
2	$200	$165	$159	$151
3	$200	$150	$142	$132
4	$200	$137	$127	$114
5	$200	$124	$114	$99
Present value of tax credits to investors		$758	$721	$670
Less: Transaction costs		($49)	($49)	($49)
Net proceeds to RTC		$709	$672	$621

Transaction Costs Reduce Gains From RTC's Sales

In general, transaction costs and management fees associated with investors' purchases of RTC properties would be subtracted from gross sales to obtain RTC's net sales revenues. As with the low income housing tax credit, investment partnerships might be formed to market the RTC tax credits to the public. The sale of RTC tax credits by investment partnerships would entail additional transaction costs to compensate the general partner and affiliates for organization and offering costs (including commissions). In a previous report on tax credits, we found that front-end costs ranged from 17 percent to almost 34 percent of equity in partnerships being marketed for low income housing tax credit projects.[3] We also found that the average equity of low-income housing tax credit partnerships was 23 percent of project costs.

We estimate additional transaction costs associated with marketing RTC tax credits would be $49 million. We assumed that equity would comprise 23 percent of $1.25 billion, as we found for the low income housing tax credit. We also made the conservative assumption that the syndication costs of the RTC tax credit program would be 17 percent of the equity of individual investors--the low end of the range for low income housing partnerships--and that they would be subtracted from the cash proceeds received by RTC.

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[3]Tax Policy: Costs Associated With Low Income Housing Tax Credit Partnerships (GAO/GGD-89-100FS, July 10, 1989).

Fiscal Impact of the Tax Credit

The role of holding costs

- A private study assumed quicker sales of RTC property with a tax credit saves holding costs.
- Quicker sales with a price reduction also saves holding costs.

THE ROLE OF HOLDING COSTS

Proponents of the RTC tax credit claim that one of its major benefits would be the savings in holding costs achieved by quicker sales of tax-advantaged properties. A private study that proposed the tax credit[4] concluded that the "benefit of selling RTC property with the RTC credit is almost 2:1 compared with the alternative of holding property for sale at a later date." This study assumed that RTC would have to wait 5 years to obtain the current asking price. The private study also assumed that RTC's annual holding costs were 9 percent of the book value of its properties and that RTC properties were subject to a 3-percent annual economic depreciation rate. These assumptions allowed the tax revenue losses caused by the tax credit to more than offset the burden of high holding costs, such as repair, maintenance, lost taxes, insurance, and economic depreciation.[5]

Because RTC's practice is to lower prices to achieve quicker sales, the RTC tax credit proposal is compared in our analysis to a price reduction, rather than holding properties in inventory. Thus, our estimate that the federal government would lose $127 million with the RTC tax credit program does not include the savings in holding costs because these savings would also be achieved if RTC sells its real estate assets more quickly by reducing prices.

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[4]GRC Economics, Economic Implications of a Tax Credit Program to Facilitate the Sale of RTC Property, September 1990.

[5]An RTC official testified on October 22, 1991, that the value of real estate under RTC control was $22.9 billion, and that the costs of maintaining that property amounted to $420 million over the period from January through August 1991. If we assume that the average balance of RTC's real estate assets in 1991 would be $22.9 billion, and maintenance costs would be incurred at the pace up to August 1991, then the ratio of maintenance costs to asset value would be 2.75 percent on an annualized basis. We did not review RTC's figures.

RTC's Past Pricing Practices

RTC's practice in setting prices inhibited asset sales by limiting ability to lower price to reflect market values

RTC'S PAST PRICING PRACTICES

We reported in previous congressional testimonies that the sale of distressed real estate assets had been much more difficult than most people had expected. From inception to March 31, 1991, RTC had taken control of real estate assets valued at about $23 billion. As of March 31, it had disposed of about $4.5 billion or 20 percent.[6]

RTC's past pricing practices inhibited faster disposition of its properties. RTC used appraised value as market value for the properties. RTC's practices prior to March 1991 were to allow sales of real estate for 95 percent of appraised value if the property was located in any of six "distressed" states. For all other states, the threshold was 90 percent of appraised value. Since most of the inventory was in distressed states, sales were generally restricted to a 5 percent variance until 6 months of marketing had occurred. After 6 months, RTC could accept 85 percent of appraised value and, after another 3 months, prices could be dropped another 5 percent.

According to RTC, its pricing directive was a hindrance to moving properties out of inventory at a higher rate because: (1) it assumed a high degree of accuracy and reliability in appraisals that it later found did not exist for many of its properties; (2) with only a 5 percent variance in prices permitted under the regulations, RTC was doomed to hold many properties for at least the initial 6 months; and (3) in declining markets, appraisal values were lagging behind real market values, making sales difficult with RTC's restrictive guidelines.

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[6]Resolution Trust Corporation: Update on Funding and Performance (GAO/T-GGD-91-43, June 11, 1991).

RTC Current Strategies for Disposing of Properties

Current RTC pricing practice.

- More flexibility to adjust sales prices to reflect market values.

- RTC offers seller financing.

RTC'S CURRENT STRATEGIES FOR DISPOSING OF PROPERTIES

Changes in Pricing Guidelines

In March 1991, the pricing guidelines were changed to permit RTC to adjust the price of distressed real estate to better reflect true market values, thereby expediting property sales. RTC approved new guidelines that allow RTC officials to sell properties at 80 percent of appraised value within 6 months of marketing, at 60 percent within 6 to 18 months, and at 50 percent within 18 to 24 months. Also, new appraisals would be required for properties still unsold after 2 years, with the appraiser fully advised of RTC's previous marketing efforts and pricing patterns. This change is too recent to determine whether it has met the expectations of RTC management.

RTC's Own Financing Program

RTC has begun a policy of seller financing for real estate assets in its receiverships. According to RTC guidelines, this financing would take the form, primarily, of fixed rate first mortgages requiring a 15 percent minimum down payment. The term of the loan would normally be 3 to 7 years with an interest rate determined by RTC field offices on a case-by-case basis under guidelines established by RTC regional offices. RTC has also offered more flexible financing in the form of cash flow participation mortgages where loan payments are tied to the property's performance. We have been monitoring this area and will report the results of our review of the cash flow financing under the portfolio sales program in the future.

Suggestions for Improving the RTC Tax Credit

- Reduce tax credit from 80 percent to 30 percent.
- Increase the number of years to claim the credit from 5 years to 10 years.
- Provide for the recapture of tax credits and penalties.
- Establish limits on transaction costs.

SUGGESTIONS FOR IMPROVING THE RTC TAX CREDIT

We were asked to provide suggestions to improve the tax credit proposal if Congress decides to enact the RTC tax credit.

Reduce Tax Credit From 80 Percent to 30 Percent of Purchase Price

The RTC tax credit proposal would allow investors to claim up to 80 percent of the purchase price plus present value of rehabilitation costs. This provision would make the RTC tax credit more attractive than the low-income housing tax credit, which is limited to the present value of 30 percent of the qualified basis of a new building that receives a federal financing subsidy. Reducing the tax credit from 80 to 30 percent of the purchase price would put the low-income housing tax credit and the RTC tax credit on a more equal footing and would allow RTC to attach the tax credit to $3.3 billion worth of properties, instead of $1.25 billion. However, the additional gain in RTC sale revenues will be the same because the offering price for each property will also be reduced.

Increase the Number of Years to Claim the Tax Credit From 5 to 10 Years

The RTC tax credit proposal would allow investors to claim fully the tax credit in 5 years. This provision would make the RTC tax credit more attractive than the low-income housing tax credit, which is generally claimed for 10 years. Extending the tax credit claim period from 5 years to 10 years would put the low-income housing tax credit and the RTC tax credit on a more equal footing, thereby minimizing distortions in investors' choices.

Recapture of Tax Credits and Penalties

If private investors were allowed to combine RTC's own financing and RTC tax credits, and investors do not meet the repayment terms of RTC's own financing, then there is a possibility that tax-advantaged properties may have to be foreclosed by RTC. We suggest that heavy penalties and full recapture of the tax credits be imposed on investors who purchase any tax-advantaged RTC property that is foreclosed by RTC in the future.

Establish Limits on Transactions Costs

Transactions costs such as developers' fees, syndication fees, legal costs, and management contracts would absorb a percentage of the cash payments from investors to RTC and/or increase the cash outlays required from investors. Congress could either include a definition of allowable costs or, alternatively, put a cap on total transactions costs to prevent excessive fees.

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PREPARED STATEMENT OF CONGRESSMAN FLOYD H. FLAKE

Mr. Chairman, My name is Floyd H. Flake and I am the Congressman from the 6th Congressional District of New York. I am also a member of the House Committee on Banking, Finance and Urban Affairs where I sit on the Financial Institutions Subcommittee.

Mr. Chairman, I come before this committee with two perspectives. The first is as a member of the House Banking Committee where I, along with my fellow colleagues, must again wrestle with the fallout. from the Savings and Loan debacle. My second perspective, is as a member of Congress from the 6th District of New York, who must deal with uncomfortable questions from my constituents as to why this nation's limited resources must be invested in "bailouts" rather than in education and housing.

As you know, the House Banking Subcommittee on Financial Institutions Supervision, Regulation and Insurance voted recently to authorize an additional $20 billion for the Resolution Trust Corporation. This $80 billion authorization request comes on the heels of a $30 billion authorization which the Congress approved only last March. So far, the government has spent about $165 billion in taxpayer funds.

Congressman Joe Kennedy (D–Ma) proposed an amendment on October 8th which was also approved by the subcommittee which includes a "pay-as-you-go provision." Whether you support or oppose Congressman Kennedy's proposal, it is indicative of the growing uneasiness on the committee over the never ending stream of tax dollars going to fund the RTC. This attitude is compounded by reports from the General Accounting Office (GAO) and the Congressional Budget Office (CBO) that thrift resolutions costs will be higher and the industry cleanup will take longer than the administration has testified. Some sources, including outgoing Chairman William Seidman, have indicated that the bailout could run as high as $600 billion. Clearly, the Administration and the RTC must be persuaded that business as usual is not a viable approach when billions of taxpayer dollars are being expended to resolve this dilemma.

To be fair to the RTC, the fault is not entirely of their own making. Under current law the RTC has only two real options to attract investors. The first is to merely cut prices and hope that at some point investors will purchase properties. While this option is viable in some circumstances, the record is clear that it has not worked. Wholesale price reductions will significantly impact local property values and therefore cause more financial institutions to seek assistance from the FDIC or RTC. In addition, a few well-heeled investors can easily take advantage of the RTC by skimming the best deals at a greatly reduced price thereby robbing the taxpayer of any chance to recover costs.

A second option for the RTC under current law is the seller financing program. As you know Mr. Chairman, the RTC has sponsored a program whereby up to $7 billion could be used to help finance purchases of commercial property. While the seller finance program is indeed a necessary program because of the disinclination of traditional lenders to extend debt financing, the program is non-recourse. That is the property acts as security for the loan. If the property goes into default, the RTC must take the property back into inventory and the taxpayer has no recourse against the debtor.

The tax credit option proposed by Senators Breaux and Kerry is not a panacea but is a creative, innovative approach to the asset sales problem. In the first place, the Asset Disposition and Revitalization Credit (ADR) will democratize the current process by allowing the millions of Americans who are paying the price of the bailout enjoy the benefits. Second, the ADR Credit will guarantee sales of assets thereby reducing the cost of the bailout. Under the proposal, the credit would not be available until the property was sold. Three, the proposal includes a so called "equity kicker" which would further reduce the cost of the bailout by providing for a 20% pre-tax payment to the government upon sale or refinancing. Fourth, the ADR credit would shift the risk of property sales to the investor and away from the government and fifth, the program would stabilize falling property values.

Mr. Chairman, I appreciate this opportunity to testify.

PREPARED STATEMENT OF NORMAN D. FLYNN

INTRODUCTION

My name is Norman D. Flynn. I am a Realtor® from Madison, Wisconsin, and am also the immediate Past President (1990) of the NATIONAL ASSOCIATION OF REALTORS®. I appear here today on behalf of a coalition of national real estate and financial institution organizations. A brief description of each organization participating in this statement and in efforts to generate sound tax policy for real estate is appended (Appendix A).

We have been asked to speak specifically to the merits of S. 1787, Senator Breaux's legislation to create a special credit available to purchasers of properties from the Resolution Trust Corporation (RTC). We have very few comments to make concerning the structure or technical makeup of the proposal. Because it is based on the low income housing tax credit, the operation and the mechanics of the credit are well known to investing taxpayers. Accordingly, the concerns that we have are not with the operation or the mechanics of the legislation, but with its objectives and with the tax policy assumptions that underly it.

Simply stated, the national real estate organizations adamantly oppose any special tax incentives for the purchasers of RTC properties.

BACKGROUND

Almost exactly a year ago, on October 27, 1990, a member of Congress inserted into the Congressional Record some comments in favor of an RTC credit. At that time, he noted that RTC held assets with a book value of approximately $14 billion. By contrast, in formal remarks on September 30, 1991, RTC Oversight Board President Peter Monroe described a portfolio of $160 billion in assets. Moreover, the RTC has already liquidated more than half of the assets it has seized. These assets total about $180 billion and were largely financial assets. According to Mr. Monroe, that liquidation is already the largest one ever in history. Now there remain $160 billion yet to be liquidated. The largest category of assets remaining in this non-liquidated portfolio is real estate.

In 1990, some members of Congress considered, but did not introduce, a credit with a total allotment of $1 billion to address a $14 billion RTC problem. Now, S. 1787 proposes a $1 billion credit allotment to solve a $160 billion problem. We have the same view of either proposal: an RTC credit is an inappropriate solution to an extraordinarily difficult problem. We do not believe that creating special RTC mechanisms in the tax code is an appropriate solution for the RTC's problems. Currently, no special tax rules apply either to the RTC itself or to properties held by the RTC. Further, the purchasers of RTC properties do not qualify for any special tax benefits. Since the creation of RTC in 1989, several proposals have been made that would grant special tax treatment to RTC properties. During the 101st Congress, the Ways and Means Committee rejected proposals that would have provided special capital gains treatment for purchasers of RTC properties, and special passive loss treatment to purchasers of these properties. We supported the defeat of those proposals. Now, during the 102nd Congress, S. 1787 has been introduced to create a special tax credit for the purchasers of these troubled properties.

S. 1787

The taxation committees of our respective organizations have reviewed earlier, similar drafts of S. 1787 several times, and have rejected each draft. We believe that any special tax incentive for RTC properties would have four adverse effects.

We believe a credit would:

- Distort prices
- Force the RTC to become a conduit for real estate
- Resuscitate tax-shelter features of the syndication industry
- Create disadvantages for banks and FDIC property

First, we believe a special RTC credit would disrupt property values. Assume that two very similar properties are both offered for sale in the same market. One property is an RTC property, but the other property has remained in private hands. If there were a special tax incentive, the RTC property would most likely have an undue advantage relative to the non-RTC property. Other factors being equal, a prospective purchaser would be drawn to the RTC property. This would artificially depress the price for the non-RTC property that has remained in private hands. We believe that such a distortion of price and skewing of tax attributes will only further erode an already troubled real estate market. We do not believe that a credit will create a floor below which prices will not drop. Rather, we believe a credit will merely create more misallocation of resources and price distortions in markets, and penalize those who have struggled to maintain their properties outside the RTC.

Senator Breaux has commented on this problem in his introductory remarks. The opening statement admits that the credit will "cause discrimination against non-tax advantaged properties." No one denies that an excess of supply is the primary reason that we face our present dilemma. Peter Monroe, President of the RTC Oversight Board, stated in a recent speech that, "No one disputes that supply and demand got out of balance during the 1980s, as a result of tax policies and loose lending practices." A credit simply will not change that very real supply problem.

The second disadvantage of special incentives is related to the issue of price, but focuses more particularly on the properties that presently remain in private hands. Above, we noted that the RTC inventory increased more than 10-fold in just one year. <u>We believe that RTC tax incentives could actually hasten the growth of the RTC, rather than ensure its successful demise</u>. A credit could actually be so counterproductive as to provide an impetus that would induce individuals to permit properties to go into default, foreclosure, and ultimately into the RTC. An RTC credit could create a situation in which the RTC would become a magnet for properties as purchasers came to demand properties with special tax benefits attached. The RTC would then become, in effect, a conduit for properties from private hands, into the RTC, and back to private hands with a tax advantage attached. Properties would emerge from the RTC in a tax-favored position, and then go into the hands of private purchasers. We do not believe the RTC should become a conduit entity.

<u>A third concern is that an RTC credit would resuscitate a syndication industry</u>. While there are still sound economic group investments and private placements today in the real estate market, the only widely available syndication programs are for the low income housing and rehabilitation credits. The low income housing credit is focused on a very narrow market niche, and serves important social functions. The product is relatively uniform, and its end use is well controlled. Similarly, the rehabilitation credit is designed to preserve our nation's heritage.

By contrast, RTC properties come in all shapes and sizes, and are not readily categorized into any particular market niche. All sorts of real estate products would qualify, in a sort of willy-nilly fashion. These credits could then be syndicated to taxpayers who might seek a "quick in, quick out" investment. By contrast, investors in the low-income housing credit must generally hold the property for fifteen years. Finally, in the past, syndication has sometimes had the unsupportable effect of artificially inflating property values. Accordingly, it would be very inappropriate to use old syndication techniques that focus on leverage and volatility in a market where prices are searching for equilibrium.

A broad revival of syndication would seriously undermine some of the policy goals of the Tax Reform Act of 1986. While the real estate industry has no particular enthusiasm for many of the provisions and policies of the Tax Reform Act of 1986, we nonetheless subscribe to its objective that taxpayers pay a "fair share." Chairman Dan Rostenkowski, in a letter to House Minority Leader Robert Michel expressing his reservations about an RTC credit proposal, stated that "any proposed relief from decisions made as part of tax reform must not reduce the fairness we all fought for in 1986. For example, proposals that would provide special benefits and allow a certain limited class of taxpayers to pay significantly less taxes than other taxpayers may fail the test of fairness."

<u>A fourth concern that we have is the effect of a proposed RTC credit on property that has not yet been turned over to the RTC, and that, under present law, would not be eligible to be held by the RTC</u>. Presently, the Federal Deposit Insurance Corporation (FDIC) has a large and growing inventory of properties from insolvent banks. The FDIC anticipates that this inventory will grow enormously over the next several years. A proposal that would favor RTC properties would, at the same time, present a substantial disadvantage to FDIC property. Thus, an RTC credit would create a very peculiar kind of competition between two government agencies, both facing the extraordinarily difficult task of liquidating real estate inventories. Chairman Rostenkowski's letter to Minority Leader Michel also expresses this concern.

The four concerns expressed above address the policy issues that we believe make any RTC credit unsupportable as a matter of policy. We note that S. 1787 has only very limited application, as it limits the total volume of available credits. While it is true that a very narrow credit is less likely to distort prices unduly, we believe that the very narrowness of the proposal renders it impotent. Thus, another concern is not so much a policy objection as it is a doubt that there will be any reliable objective standard by which to evaluate the effectiveness as a stimulus of this particular RTC credit, should it be enacted.

S. 1787 is designed to implement a sort of "pilot" tax program. An allocation of $1 billion would be dedicated to the creation of an RTC credit. In 1990, when the concept of an RTC credit was first presented in Congress, proponents suggested that a $1 billion credit be allocated against a $14 billion RTC inventory. Arguably, the RTC credit could then have provided a stimulus to sell about one-fourteenth, or 7% of the RTC property. While 7% is still a fairly small increment, it would be possible to develop some objective standards for evaluating the performance of the credit for aiding the sale of property. S. 1787 again proposes a $1 billion credit allocation that would be applied against a $160 billion inventory. Thus, the credit would apply only against 5/8 of 1% of RTC's property. Evaluating the credit's effectiveness as a stimulus, when it would be available for only 5/8 of 1% of the properties in the RTC, will be a difficult and imprecise task. We applaud the fiscal restraint of those who propose a very narrowly drawn credit, but we do not believe that such a small credit could provide any meaningful relief for an extraordinarily difficult problem. Even if it were very successful in aiding the liquidation of properties, it would be impossible to make the extrapolation that a credit would be a stimulus for large-scale liquidations.

Finally, we call attention to an economic underpinning of the credit proposal. An analysis that was used frequently to assess the relative merits of the 1981 tax cuts and the 1986 tax reforms focuses on the time value of money to determine the present value of tax benefits that are spread over a term of years. Under such an analysis, the current tax benefits of using an RTC credit would actually be more valuable to those who would qualify for the credit than if purchasers were simply able to deduct the purchase price in the year of acquisition. S. 1787 would allow a credit equal to 80 percent of the purchase price, claimed ratably over five years. If we assumed an annual discount rate of 7 percent, the present value of the credit (i.e., its value if it could be taken in full in the year of purchase) is about the economic equivalent of 70 percent. In other words, an 80 percent credit over five years is about equal to a 70 percent credit today. For a taxpayer in the 31 percent bracket, a 70 percent credit is comparable to an income tax deduction for more than 200 percent of the actual purchase price of the property. Such a benefit may be exactly what the drafters intended, but we believe it is crucial to disclose that fact. We note, too, that even at discount rates well below 7 percent, the value of the 80 percent credit is still greater than the value of a current deduction, or expensing, for the purchase price.

We, therefore, implore Congress to resist all temptation to create any special RTC incentives. Do not be deceived; the present tax policy for real estate is destructive, and the policies enacted in 1986 cry out for revision. An RTC credit will not solve the underlying problem of a deeply flawed real estate tax structure.

A BETTER SOLUTION

Under present law, rental real estate activities are segregated from all other business activities, and losses from rental properties may not offset any other income. Accordingly, a real estate professional who owns a business that has both rental and nonrental activities is not permitted to treat that business as one integrated unit. Rather, any losses attributable to rental real estate are simply carried over from year to year. Over time, this has a disastrous effect on cash flow as owners of rental properties are unable to deduct even their cash, out-of-pocket expenses. When the pressures on cash flow become too acute, properties go into default and foreclosure. This puts enormous pressure on financial institutions, and so many properties from savings and loans ultimately end up in the RTC.

The real estate industry believes that the best thing that we could do for both the nation's financial institutions in general and for the RTC in specific is to correct the passive loss rules. Again, we urge Congress to resist the temptation to create only special RTC incentives. Relief is needed for the entire real estate industry.

We believe it will be impossible to have a sound real estate market until people in the real estate business can deduct their losses from their business activities. Until rental properties, both in the RTC or in private hands, lose their taint, there cannot be an economic real estate market. To use an old cliche, a rising tide raises all ships.

The passive loss rules, as presently configured, are actually an obstacle to making a market for RTC properties. Assume that an individual wishes to acquire an RTC property that is in need of repair or improvement to make it habitable or commercially viable. An individual who acquires the RTC property (or any other real estate, for that matter) would be permitted to deduct the costs of renovation, repair, and other operating expenses only to the extent that individual had rental income. As a general matter, RTC properties do not currently produce substantial amounts of income. Why then, should an individual purchase an RTC property (or any other real estate), make substantial cash expenditures in an effort to rehabilitate the property, and then be penalized for tax purposes? In other words, the inability to deduct even operating expenses is an enormous drag on the real estate market.

If Congress were to enact S. 1257, the Boren-Breaux-Symms passive loss relief bill, the market for all real estate properties would, in our judgment, improve. The passive loss bill will not cure all problems in real estate markets. The problems are far too profound for any one piece of legislation to be a cure-all. At best, the legislation would slow the rate of foreclosure. Enactment of the passive loss relief legislation would have the enormous advantage of freeing up cash flow for the owners of rental properties who are in the real estate business. Cash flow is essential in today's market if a property is to stay in private hands, and out of foreclosure, the FDIC, or the RTC. The passive loss relief would do more to provide cash flow than any other single proposal currently available.

The legislation would not revitalize tax shelters, because the legislation requires that real estate professionals who would qualify for relief must be material participants. With the owners of rental real estate as material participants, the government is guaranteed that a professional standard of care would be applied in the development, ownership and maintenance of buildings. This very positive signal would do much more to create a floor under real estate values than would an RTC credit that was available only to a limited number of properties. The real estate industry stands ready to offer a means to "pay for" the enactment of passive loss relief, and urges Congress to move as soon as possible during this session of Congress toward the enactment, in 1991, of passive loss relief.

In the best of all possible worlds, Congress would not only enact the passive loss relief for rental real estate, but it would also reenact a capital gains differential. Anecdotal evidence is readily available that suggests that many individuals who own viable properties and who have held properties for a long period, are holding on to their properties rather than sell them and take the tax beating associated with current law. This exacerbates the perception that real estate markets are dormant or stagnant. THE NATIONAL ASSOCIATION OF REALTORS® has commissioned research on the effect on real estate values of the Tax Reform Act of 1986, and has discovered that the rules enacted in 1986, particularly passive losses and capital gains, have contributed to property value declines of anywhere from 2% - 18%, depending on the market. That research has also shown that correcting the tax laws, especially the capital gains and passive loss rules, would provide the biggest "bang for the buck" in the same markets that were most adversely affected by tax reform. Accordingly, we urge Congress to act rapidly to correct these two features of the Tax Reform Act of 1986.

Providing passive loss relief and restoring capital gains, more than any special RTC incentives, would go the furthest to make markets for RTC properties, and to provide relief for individuals who have been able to maintain their property and keep it out of foreclosure and out of the RTC. The RTC will operate most efficiently with sound tax policy, not with special tax policy. We advocate tax policy that would benefit all owners of real estate, and not just one particular market segment. We therefore oppose the special RTC credit in S. 1787, and urge Congress to act quickly on passive loss relief and to restore capital gains.

CONCLUSION

In summary, Mr. Chairman, the RTC has come down a long and tortuous road and they have a long and tortuous road ahead of them. They have made progress and they are continuing to make progress. The national real estate organizations have worked, and will continue to work with the RTC. We wish to see the RTC succeed in disposing of its properties. It is crucial to the real estate industry, to our financial institutions and to the future of our nation, that the RTC succeed in an environment founded on sound tax policy for all real estate, and not in a world of gimmicks and artifice.

Organized real estate groups, and many associations representing financial institutions favor creating fair tax rules for all real estate properties, and not special breaks for properties purchased from the RTC. The passive loss rules should be changed across the board for real property owners, and capital gains taxation should be restored. These two steps would increase values, encourage purchases of properties from institutions, and help facilitate troubled property work outs. Special tax breaks for RTC purchases would be counterproductive, because private properties would be at a competitive disadvantage, tax syndications would reappear, and values of real estate would be artificial. We reiterate: the RTC would operate most efficiently with sound tax policy, not with special tax policy.

APPENDIX A

Organizations Submitting Statement

... Chairman, this statement is submitted to the Committee on Finance Subcommittee on Taxation and Debt Management on behalf of the national real estate organizations that represent those individuals and firms that own, operate, develop and finance income producing real estate. The organizations are:

International Council of Shopping Centers (ICSC):

ICSC is the trade association of the shopping center industry. ICSC's 27,000 members are engaged in the day-to-day activities of designing, planning, constructing, managing, financing, developing, leasing and owning shopping centers and their retail stores. The approximately 25,000 members located in the United States represent a majority of shopping centers in this country. ICSC is headquartered at 665 Fifth Avenue, 11th Floor, New York, New York. 212/421-8181. Its Washington office is located at 1199 N. Fairfax Street, Suite 204, Alexandria, Virginia. 703/549-7404.

National Association of Industrial and Office Properties (NAIOP):

NAIOP represents over 5,500 companies who develop, own and operate industrial, office and retail properties in the U.S. and Canada. Working with the national office, NAIOP's 69 U.S. chapters stress research, education and public policy advocacy in achieving their goal of creating a better quality of life. NAIOP is headquartered at 1215 Jefferson Davis Highway, Suite 100, Arlington, Virginia. 703/979-3400.

National Association of Realtors® (NAR):

NAR is the Nation's largest trade and professional association with more than 800,000 members across the country. NAR's membership is composed of REALTORS, who are generally residential and commercial brokers or salespeople, as well as property managers, developers and owners of real estate and REALTOR-ASSOCIATES, a membership category made up largely of salespeople. Working for America's property owners, NAR provides a facility for education, research, and exchange of information among its members and to the public and government. NAR is located at 777 14th Street, N.W., Washington, D.C. 202/383-1000.

National Council of Community Bankers (NCCB):

The National Council of Community Bankers is a trade association of insured depository institutions that provide community financial services. The National Council is dedicated to freedom of choice of financial powers, and preservation of the dual banking system and the federal deposit insurance system. The National Council represents approximately 350 insured depository institutions, who have over 4,000 branches nationwide. Its offices are located at
1101 15th Street, N.W., Suite 400, Washington, D.C. 202/857-3100.

National Multi Housing Council (NMHC):

NMHC represents the interest of the larger firms in the United States participating in the multifamily rental housing industry. The members of NMHC are engaged in all aspects of the development and operation of rental housing, including the ownership, building, financing, management, and conversion to condominium or cooperative ownership of such properties. NMHC is headquartered at 1250 Connecticut Avenue, N.W., Suite 620, Washington, D.C. 202/659-3381.

National Realty Committee (NRC):

NRC serves as "Real Estate's Roundtable" for national issues vital to the real estate industry. A leading public policy advocate, NRC primarily addresses capital and credit, tax, environmental and investment-related issues. NRC members, who meet frequently in roundtable fashion and testify often before Congressional and regulatory panels, are America's principal real estate owners, advisors, builders, investors, lenders and managers. NRC's offices are located at 1250 Connecticut Avenue, N.W., Suite 630, Washington, D.C. 202/785-0808.

The National Association of Home Builders (NAHB)

The National Association of Home Builders (NAHB) represents more than 155,000 member firms through a network of 760 local and 44 state affiliated associations. NAHB members can be found in every type of community across the nation, representing rural and urban interests. While the association was founded to represent the small home builder, it has expanded through the years to include the diversified builder. NAHB is located at 1201 15th Street, N.W., Washington, D.C. 202/822-0200.

Prepared Statement of Michael J. Graetz

Mr. Chairman and Members of the Committee: I am pleased to be here today to present the Administration's position with respect to S. 1787, a bill to provide a new tax credit to purchasers of real property held by the Resolution Trust Corporation (RTC). Although the Administration fully supports efforts to minimize the costs of the savings and loan cleanup, we object to the RTC property credit for a number of reasons. Before discussing our objections, I shall describe the provisions of the bill.

SUMMARY OF S. 1787

S. 1787 would grant purchasers of real property held by the RTC a tax credit to be claimed over a 5-year period. The credit may have a present value of as much as 80 percent of the purchase price of the property. The exact percentage for any particular property would be set by the RTC in an amount that the RTC concludes is necessary to sell the property, but the aggregate amount of credits would be limited to $1 billion. If the purchased property requires rehabilitation or is not fully constructed, the credit could also apply to the estimated rehabilitation or construction costs, as agreed to by the RTC and the purchaser. A taxpayer's basis in purchased property would not be reduced by the amount of the credit allowed. As a result, a purchaser receiving a tax credit for as much as 80 percent of the property's cost would nevertheless be entitled to depreciation deductions for the full purchase price of the property. Upon a resale of the property by a recipient of the credit, the RTC would be entitled to receive 20 percent of the difference between the amount realized from the sale and the amount the recipient paid for the property.

The RTC property credit would be added to a list of business tax credits under the Code.[1] However, certain restrictions currently applicable to other business tax credits would not apply to the RTC property credit. First, the RTC credit would not serve to reduce the maximum benefit otherwise available to corporations for other business tax credits. The RTC credit, however, generally would not be allowed to reduce by more than 50 percent the tax liability due after application of the other credits. Unlike other business tax credits, the RTC property credit also could be used by all taxpayers to offset up to 50 percent of their alternative minimum tax liability.

In addition, individual taxpayers would be exempt from the limitations under the passive activity loss rules enacted under the Tax Reform Act of 1986 for up to $50,000 of RTC credits. Finally, any loan extended by the RTC in connection with the purchase of property to which the credit applies would be exempt from the original issue discount rules.

ADMINISTRATION POSITION

The Administration opposes S. 1787. The idea of using tax incentives in the context of the savings and loan problem is not a new one. In 1981, the Congress coupled substantial tax incentives with direct financial incentives for savings and loan associations. During 1988 and 1989, the Federal Savings and Loan Insurance Corporation (FSLIC) resolved 199 insolvent financial institutions in 96 assisted transactions, which combined direct federal financial benefits and tax savings. The tax benefits were considered necessary because FSLIC did not have the financial resources to liquidate insolvent institutions even where liquidation would have minimized the cost of resolving the institutions.

The nation's experience in combining tax and direct financial benefits in these transactions has not been a happy one. Indeed, the combination of tax and direct financial benefits in the 1988/89 transactions has created perverse incentives for institutions to hold assets and to minimize their value when sold, as well as incentives to maximize expenses, when institutions believe that both direct reimbursement from the Federal Deposit Insurance Corporation (FDIC) and tax deductions for the reimbursed expenses are available. In enacting the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), Congress repealed the special tax benefits available in the 1988/89 transactions, making the judgment—which remains' sound today—that the creation or maintenance of artificial tax-driven transactions should be avoided because they ultimately will increase overall costs to the Federal government. Although S. 1787 contains limitations on the total amount of tax credits that could be claimed and thereby avoids the unlimited blank check aspects of some prior tax incentives, it presents major difficulties.

[1] The business tax credit provisions coordinate the use of most business credits, such as the research credit and the low-income housing credit.

S. 1787 empowers a Federal agency, the RTC, to deliver tax reductions in amounts it selects to taxpayers it chooses in circumstances where others who purchase similar assets—whether from the RTC or from private sellers—will not enjoy such tax relief. This legislation inevitably will produce different tax burdens for similarly situated taxpayers and will foster a perception that the tax system is unfair. This seems particularly likely to occur in circumstances such as these where the RTC can best reduce its own costs by channeling these tax credits to taxpayers with sufficient taxable income to make the tax benefits readily usable without delay.

Moreover, the tax credit provided in this legislation is not the most efficient means to achieve the legislation's goal of expediting the RTC's sales of real property that is expected to have significant management, maintenance and other holding costs. Analytically, it is clear, for example, that, in circumstances where savings to the government are possible from the RTC selling property sooner and reducing its holding costs, the proposed tax credit would be more costly for the government than a reduction in the RTC's minimum price for accepting bids. Buyers, who face higher borrowing costs than the Treasury, would value the tax credit, which is spread over five years, using a higher discount rate than the Treasury. Buyers might also discount the value of the tax credit to reflect the risks that the full credit might not be used. This could occur, for example, if subsequent legislation were to restrict the use of the tax credits, if a buyer were to sell the property within five years of the purchase date or if the taxpayer has insufficient taxable income to fully use the credit in one or more of the taxable years of the relevant 5-year period.[2] There is no economic rationale for offering buyers a tax credit in lieu of explicit price reductions or rebates. As a result, the credit proposed in this legislation would add unnecessarily to the government's cost of the savings and loan cleanup.

Some proponents of a tax credit approach have claimed that, because a tax credit would support higher prices for RTC real properties, nearby real estate would benefit. Such a claim is not correct. The value that current and potential owners place on property depends upon the net present value of future income they expect to receive from owning and managing the property. A tax credit for RTC property would not affect the expected future income of properties located in the same area as the RTC property, and therefore would not affect their appraised value. While potential buyers of commercial property not owned by the RTC would observe nominally higher prices on RTC sales of property that qualified for the tax credit, they could be expected to understand and take into account the effect of the tax credit on the actual purchase price.

Proponents of the tax credit approach also claim that the tax credit would expand the number of potential buyers who have sufficient equity to buy RTC property. The tax credit, however, would be of value only to potential buyers with sufficient taxable income. Accordingly, tax-exempt entities (such as pension funds and foundations), nonprofit organizations, which have been important purchasers of multi-family affordable housing properties, and other potential buyers lacking an adequate tax base would not value a tax credit. The bill does not even require that the RTC use the least costly method of disposing of its property—a minimum protection for the taxpayer.

In addition to our fundamental objection to the RTC's using tax credits to stimulate sales of property, S. 1787 also raises other tax policy and administrative concerns. For example, although a purchaser of a property would be entitled to a tax credit equal to as much as 80 percent of the property's purchase price (as well as its completion and rehabilitation costs), the purchaser also would be entitled to claim depreciation with respect to the entire purchase price of the property. This could result in a purchaser receiving total tax savings that exceed the property's purchase price.

S. 1787 also provides exemptions for the RTC property credit from the generally applicable provisions of the alternative minimum tax and the passive activity loss rules. The minimum tax and passive loss rules were cornerstones in implementing a principal goal of the Tax Reform Act of 1986: elimination of tax shelters and their destructive effect on our nation's economy. The proposed exceptions in this legislation to the minimum tax and passive loss rules would not only limit the scope of these important rules but also would invite their further future erosion.

Finally, this legislation would lead to increased transaction costs for both the government and purchasers of RTC property. And the government's costs would not end with its disposition of the property. The Internal Revenue Service would be bur-

[2] Any increased taxes resulting from the actual occurrence of the events being discounted by buyers would only partially mitigate the loss to the government from the discounting of those events.

dened with the cost of monitoring compliance with the detailed credit provisions for many years following the property's disposition by the RTC.

REVENUE IMPLICATIONS

Over the period 1992–1996, Treasury estimates the revenue loss of S. 1787 to exceed $1 billion. The cumulative revenue loss exceeds the $1 billion aggregate cap on tax credits principally because S. 1787 does not require that basis in credit property be adjusted for the credit, and therefore would serve to increase depreciation allowances.

No provision to offset the revenue loss from S. 1787 has been proposed. As a result of preliminary discussion with OMB, we believe that this revenue loss is included under paygo provisions of the 1990 Act. Our preliminary view is also that this provision is not exempt from paygo under the deposit insurance provisions of the 1990 Act.

STATEMENT OF SENATOR JOHN F. KERRY

Mr. Chairman, thank you for the opportunity to appear before the Subcommittee today to present my views in support of Senator Breaux's bill, the Asset Disposition and Revitalization Credit Act of 1991. I am an original co-sponsor of the bill, and I sincerely hope the Senate will have an opportunity to consider this legislation this year.

The New England region has been very severely affected by the current economic recession. In my State of Massachusetts, as in most States, there is a large inventory of real property under the control of the Federal Government. With news last week of Citicorp eliminating its dividend, and the Administration asking Congress for a recapitalization of the FDIC as well as more money for the RTC, I think we in Congress need to take more action to solve this mess than merely to give more and more of the taxpayers money to the FDIC and RTC managers.

Not very long ago, the Administration came to the Congress for an RTC recapitalization. I sat through hearings on the Banking Committee at that time, wondering why this mess seemed to be getting worse instead of better. Now the Administration is coming back for even more money. Something is happening that is very wrong here, and I for one do not believe we in Congress can simply sit back and keep on giving them more and more money, year after year, without looking for some way that we can help turn the general real estate situation around.

Mr. Chairman, I have been advised by my constituents and by witnesses appearing before the Senate Banking Committee that many potential investors have grown tired of trying to deal with the incredible bureaucracy that has become the RTC. I am hopeful that the restructuring of the RTC contemplated by the Banking Committee and the recent installation of Mr. Casey will compel the RTC to accelerate asset sales.

However, many potential buyers of the RTC's distressed properties will not respond to these changes but will defer purchases until some "speculative gems" become available at bargain-basement prices.

This "auction block" mentality is not only a threat to the entire real estate market in this country, but it is a source of concern to me because there are risks the deals the RTC might make to get properties moving will be excessively generous to private speculators. Questions of this nature were raised two weeks ago in House Banking Committee hearings.

Yet, the only alternative right now to a larger financial bail out is more aggressive auction price-cutting of real estate to move the properties out.

Besides generous price cutting, the primary tool the RTC now has to assist in the sale of its inventory is the financing it can offer. Because the banks are too hard pressed to finance some of the necessary sales, the RTC can offer up to 70 percent financing—they have $7 billion in non-recourse financing authority. There are questions here too that the public has a right to ask, in regard to how the financing authority is being allocated. Questions of this nature also came up two weeks ago in the House Banking Committee.

Unfortunately, Mr. Chairman, the taxpayers are the ones who are at risk in these deals. If the economic prospects for a property do not turn around, the RTC will end up owning it again, and the money we thought we had received will not be there. If the real estate held by the RTC or the FDIC is auctioned at a bargain-basement price, the taxpayers lose a large part of that value too.

What Senator Breaux's bill, S. 1787, does is to provide a way for the Congress to stimulate the demand for these properties by new investors, who will buy them with their own money, and the additional demand from new investors will help support the prices of real estate. On a dollar for dollar basis, the taxpayers are better off with a tax credit than under the existing situation. More importantly, by providing the financing incentive into the tax code in the form of the Asset Disposition id Revitalization Credit, the Congress will remove the cloud of back-room dealing with investors. The terms the investors will be attracted to will be up front and publicly known.

There is no incentive in the tax code right now for potential buyers to take over the RTC and FDIC properties at their current prices. And the impression is very strong that RTC and FDIC real estate prices will be cut further to move the properties quicker. Cutting the price is the only tool other than financing that the property managers can use to make a property more attractive, under the current law.

What Senator Breaux's bill does is provide the RTC with another tool to make its properties more attractive. The RTC can add a fixed amount to tax credit to a sale, which the buyer can use to offset other income tax liability. Some people might say, why not just cut the price? Why use the tax code? The answer, Mr. Chairman, is that it may not appear to make any difference to the government—but it does make a big difference to the potential investor—to use a tax credit instead of cutting the price. It also can make a big difference to every other real estate owner in the local community to allow an FDIC or RTC property to sell without slashing its price below everything else in the market.

Let me make two brief arguments specifically in favor of the tax credit, and I will finish with a more general idea about this recession we are currently suffering from.

First, this tax credit is designed to work exactly the same way as the Low Income Tax Credit. There are no fancy new tax law innovations in Senator Breaux's bill. The Finance Committee is not being asked to approve a "reopening of the 1986 Tax Reform Act." We know that the Low Income Tax Credit has worked to bring in new money for low income housing. What Senator Breaux and I want this Committee to approve is a way to bring in new money for the distressed real estate that the Federal government is already being forced to buy—so that the Federal government can sell it and get the taxpayers' money back more quickly.

Second, as a member of the Banking Committee, I can tell you that the banks are up against the wall right now with real estate loans. They are not very interested in putting more money into real estate—so bank financing is not an option for increasing the economic demand for RTC properties. The large real estate investors, who might be able to take some of the RTC inventory are the very ones who are negotiating with their banks for restructuring. Where can new capital come from? The answer is that it must come from the small and middle-size investor. The Low Income Tax Credit has shown us how to bring in the small and middle-size investor and his additional money into the market.

There are three choices here: the Federal government can hold on to this inventory of property for many more years, or it can sell it sooner at distressed, bargain basement prices. The third choice is to sell it at the higher price, but offer investors an incentive to buy the property. The third choice is created by S.1787. We get the taxpayers' money back immediately, and re-bate some of it in the form of the tax credit over the next 5 years.

In economic terms, the technique of cutting the prices of the property just forces existing properties to compete with other existing properties for a small number of qualified investors. There are too few of these investors to give any relief to this depressed market. **The Asset Disposition and Revitalization Credit Act** makes it possible to bring more, new investors into this market. It will stimulate the demand for this kind of investment and it will bring in non-bank financing. To me, as a member of the Banking Committee, that is one of its most important features. My Committee can't do it, however, because it is a matter for the Finance Committee. That's why I am here today. We need your help.

Finally, Mr. Chairman, this recession we are currently suffering from is getting worse, not better. Some economists are warning us of a "double dip." In 1929, the stock market crash set off a chain reaction that led to a growing number of bank failures. I am worried that the same thing is happening again, except this time it was the real estate crash that will be the cause of the prolonged depression.

I don't see any leadership coming from the Administration to help us get out of the economic mess we are in. But I do see the opportunity now for Congress to propose new ideas. This is what Senator Breaux has done—and I am very pleased to support him in this innovative idea to stimulate some demand for the sector of our economy that seems to be falling and falling without a bottom.

the idea of a tax credit to help one small segment of government-owned real estate find new investor, will send a signal that we care about what is happening. It will send a signal that we care about *all real estate prices*, not just the government's own property, because the **Asset Disposition and Revitalization Credit**

Act works to protect the prevailing market price in every locality where the RTC has a property to sell. I we don't give the FDIC and RTC this too, it will have no choice but to cut the price—and undercut everybody else in the market who will have to adjust to the lower prices.

But the most important reason to support the idea of a tax credit is that it brings in new buyers, who bring with them their own new financing, from sources outside the banking system. The tax credit simulates economic demand and puts the focus of that demand on the distressed real estate market, in the same proven, effective way that the Low Income Tax Credit has done.

PREPARED JOINT STATEMENT OF NICHOLAS P. KOSKORES AND JOHN P. MANNING

Mr. Chairman, thank you for the opportunity to appear before the Subcommittee today to present my views in support of S. 1787, the Asset Disposition and Revitalization Act of 1991.

My name is Nicholas P. Koskores and I am president of The New England Council, Inc. I am accompanied here today by Mr. John P. Manning, President of Boston Capital Partners, Inc. and a valued member of our association.

The New England Council is a unique organization comprised of businesses and institutions dedicated to improving the economic vitality and overall quality of life in the six state region. Founded in 1925 by business leaders and the New England Governors, the Council is the nation's oldest regional business association and the most successful example of regional cooperation in the United States. Council membership includes manufacturers, professional and financial services, wholesale and retail distributors, utilities, health care facilities and educational institutions.

The New England Council supports S. 1787 introduced by Senator Breaux and cosponsored by Massachusetts Senator John Kerry.

The recession in New England began a year and a half before the national recession and has been much deeper. Total employment in New England peaked in January 1989 and by March 1991 had fallen 6.5 percent. In comparison, national employment continued to rise through June of 1990—17 months after New England had reached its peak—and fell only 1.5 percent through March of 1991.

Employment data in New England does not tell the whole story. Sector by sector our industries have been losing market share to international competition or to other less recession-impacted regions.

In an effort to combat our economic plight, the public and private sectors have joined together to implement an ambitious program of economic renewal. With our excellent manufacturing and research capabilities, New England will regain the economic prosperity enjoyed in the 1970's and 80's.

Two significant problems could restrain and ultimately derail our recovery program. The first is the "credit crunch." In spite of the comments to the contrary, the credit crunch is real and is continuing to add to the economic chaos in New England. Banks, insurance companies, pension funds and other traditional lenders have become increasingly reluctant to invest in commercial real estate, small business and other basic industries essential to economic recovery.

If New England and other recession impacted areas of the country are to recover, these five recommendations should be followed:

First, lenders must be encouraged to make prudent loans. Financial credit, the lifeblood of economic recovery, must not be denied to sound borrowers;

Second, regulatory policies which have classified commercial real estate and small business as the most unworthy of loans for risk-based capital purposes must be revised and replaced with policies that encourage sensible lending;

Third, bankers and other lenders should be encouraged to work constructively with borrowers experiencing temporary difficulties;

Fourth, sensible refinancing of economically sound commercial loans should be encouraged and

Fifth, alternative or non-traditional sources of liquidity should be developed to supplement conventional sources.

A second problem which has the potential to retard economic recovery is the oversupply of commercial real estate. New England, like the Southwest, is burdened by an excessive supply of commercial properties. In addition, declining real estate values due to the depressed real estate market have resulted in a significant reduction in New England property values. This unfortunate situation drains our economy of jobs, tax revenues and overall wealth.

One of the most important benefits of the Breaux/Kerry legislation is the stabilization of property values. S. 1787 would halt the downward slide of property values by establishing a floor for FDIC and RTC properties. Owners of private sector commercial properties would clearly benefit from this stabilization as would public sector agencies who must try to sell seized properties at the highest possible price.

A second benefit of S. 1787 is that it will significantly reduce the oversupply of government owned property on the commercial market. Many of these properties ended up in government control as thousands of savings and loans and other financial institutions were closed by regulators. The Federal Government is now the largest owner of commercial and residential real estate in the country. Economists have estimated that the RTC and FDIC will eventually own more than $60 billion in real estate or approximately one percent of all private real estate in the United States. This oversupply of government owned property has "crowded out " the sale of privately held property and has severely hampered the ability of the market to efficiently transfer this real estate back to the private sector. S. 1787 helps to overcome this problem by providing an alternative source of equity funding that does not compete with the private sector for limited debt funding at financial institutions.

Finally, S. 1787 helps to reduce taxpayer exposure. We in New England are increasingly concerned about the billions of tax dollars authorized by Congress to fund the Resolution Trust Corporation and the slow pace of asset sales to date. As you know Mr. Chairman, Treasury Secretary Nicholas Brady and FDIC Chairman William Seidman appeared before Congressional committees this summer requesting $80 billion in additional funding for the RTC. More recently, the Congressional Budget Office (CBO) and the General Accounting Office (GAO) have testified that this additional funding will not be sufficient and that billions more in taxpayer dollars will be needed to bail out the savings and loan industry.

While the Congress engages in this annual controversy over RTC funding, the RTC and FDIC continue to close financial institutions and continue to accumulate billions of dollars in assets.

Although the RTC has been modestly successful in paying off depositors and marketing its huge financial portfolio, real estate assets are selling at an extremely slow pace. In spite of a few well publicized sales, the RTC has sold less than 5 percent of its entire portfolio of assets. Neither the taxpayer nor the real estate industry can continue to support this growing supply of government owned real estate.

Clearly, the Asset Disposition and Revitalization (ADR) program envisioned by Senators Breaux and Kerry can help decrease this hemorrhaging of taxpayer dollars.

The ADR Credit will be a limited program designed to expedite the sale of "hard to sell" RTC and FDIC properties. The Credit which is based on the successful low income tax credit, will be a 5 year credit based on the acquisition price and rehabilitation expenditures of a selected number of RTC and FDIC properties. The proposal provides for a $50,000 exemption from the passive loss rules and will be allowable against the Alternative Minimum Tax (AMT).

The ADR tax credit will: –

- STABILIZE declining real estate values;
- DEMOCRATIZE the RTC and FDIC sales process by permitting average investors to participate through the syndication process;
- SAVE taxpayers an estimated $2.00 for every $1.00 used to finance the program;
- GUARANTEE the sale of RTC and FDIC property as the credit can only be utilized after a sale by the RTC or FDIC;
- ENSURE that property sold by the RTC or FDIC will not revert to the government if the project again fails.

The ADR tax credit will not be:

- available for properties that can be sold for market or near market prices; or
- accessible to any officer, director, or substantial shareholder of a failed S&L acquired by the RTC.

Members of both the House and Senate are supportive of the ADR Credit proposal and view the concept as an innovative way to finance the sale of a limited number of distressed RTC and FDIC properties. Focus groups conducted among average citizens and potential investors in nine major cities revealed strong support for the ADR Credit as a means of reducing taxpayer exposure and maintaining property values.

Some individuals have argued that the credit is an inefficient way to stimulate the real estate industry. These so called "classical" economists believe that the market should not be influenced by the tax code and that eventually the law of supply and demand will "clear" the market of government owned properties. While these individuals may be right on a conceptual basis, they can predict neither the probable cost of the bailout nor the number of years the real estate industry will remain

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depressed due to the overabundance of RTC and FDIC properties. The tax credit mechanism has proved to be an effective tool in attracting investor dollars to low income housing and should prove as efficient in "clearing" the market of RTC and FDIC property.

A more noteworthy argument suggests discrimination against non-tax advantaged properties. While this contention has some merit, it ignores the fact that private commercial real estate has not sold and will not sell as long as an overabundance of government owned properties depresses the market, reduces available credit and stifles all sales activity. Obviously, there can be no discrimination if local markets remain dormant.

Despite the possibility of market discrimination once the ADR Credit program is implemented, the stabilization of property values and the resurgence of real estate markets will more than offset any incidental damage to some private commercial properties.

The ADR Credit is designed to be a selective program, with limited resources and with the objective of carefully stimulating local real estate markets while maintaining property values. By reducing the oversupply of government owned commercial properties and infusing new investor capital into these local markets, the ADR Credit will revitalize deteriorating real estate much like the Rehabilitation Credit has restored many of the nation's blighted urban areas.

Arguably, the ADR Credit is not a panacea. Nevertheless, it *is* a creative first step in the return of commercial properties to the private sector and in the re-creation of a healthy and prosperous real estate market.

Prepared Statement of Congressman Bill Orton

Mr. Chairman, I would like to thank the Subcommittee for the opportunity to express my views on S. 1787, a bill to amend the Internal Revenue Code of 1986 to encourage the sale of real property held by the Resolution Trust Corporation (RTC) by allowing a credit against income tax to purchasers of such property.

At the outset, I would like to commend Senator Breaux and Senator Kerry for their proposal to provide the RTC with a mechanism to promote the disposition of real estate assets acquired from failed financial institutions. While I cannot support this proposed legislation in its current form, I believe it represents an important acknowledgement of the significant, indeed critical, impact tax policy can have on real estate markets in terms of ability to sell, selling price, and the timing of such sales. In this regard, the bill constitutes a crucial step in understanding the actions which are needed to help reverse the decline in the real estate market.

I believe that it is clear that the series of tax changes the Congress adopted in the last decade, ranging from the exaggerated incentives for real estate adopted in the 1981 tax bill to the emasculation of real estate tax incentives in the 1986 tax bill, have had a direct and immediate impact on the real estate markets and have helped to precipitate the Savings and Loan Crisis, the current wave of bank failures, and the emerging insurance crisis. Each of these crises is directly or indirectly related to the instability in the real estate market which has resulted from these changes. In turn, the ripple effect of these changes has now also helped to undermine the market for investment grade real estate.

In view of the relationship between tax policy and real estate markets I have described, I believe that an attempt to resolve the problem RTC is encountering in selling properties in a depressed real estate market by creating a special tax treatment for RTC properties has the potential for being a very serious mistake. The consequence of adopting a tax incentive applying only to the sale of RTC properties would be that while sales of RTC real estate would increase we would have, in effect, created a statutory disincentive to investment in other privately held real estate. The result of this could be to set off a chain reaction reducing the value of privately held real estate, further depressing the market for that real estate, increasing the default rate on those properties, undermining the financial institutions holding the mortgages on those properties, and in turn increasing the failure rate of those institutions. Ultimately this measure, rather than reducing the overall inventory of real estate held by the government, could have the wholly unintended effect of increasing the government's real estate holdings.

Mr. Chairman, I would like to take this opportunity to propose to this Subcommittee an alternative approach to the RTC tax credit which I believe would not only improve the sales of RTC properties but also help improve the real estate market generally.

First, I would attach to the House or Senate banking reform bill or the RTC refinancing bill an amendment to eliminate the disparity in the passive loss rule under

Section 469 of the Internal Revenue Code similar to the proposal under H.R. 1414 and S. 1257. The Joint Committee on Taxation (JCT) in 1990 estimated that this change would have a nominal negative impact on revenues of $3.2 billion over 5 years. However, I submit to the members of this panel that this cost would be inconsequential compared to the $80 billion requested by the Administration to pay for the "final portion" of the Savings and Loan bailout. Moreover, this does not even address the $70 billion in additional borrowing authority now proposed for the FDIC, or the huge additional costs which the growing crisis in the insurance industry could pose.

Second, I would amend Sections 1221 and 1231 of the Internal Revenue Code to provide long term capital gain treatment for real estate. The JCT has estimated that this change would provide a short term gain in revenue to the Federal government.

These two changes would, I believe, have an immediate significant positive impact on the value of real estate in general. The resultant improvement in the depressed real estate market would have a collateral impact of helping to relieve the problem of RTC in selling off their real estate inventory; easing the pressure on weak Savings and Loans and banks by increasing the value of their real estate portfolio and again, making it easier to sell off such properties; and finally, helping to avert the looming insurance crisis by helping to raise the value of their substantial real estate investments.

Mr. Chairman, I would like to thank you again for providing me the opportunity to address the Subcommittee. I would be happy to respond to any questions that you or the other members of the Subcommittee might have on my evaluation of S. 1787 or on my suggested alternative to this bill.

PREPARED STATEMENT OF ROBERT D. REISCHAUER

Mr. Chairman and Members of the Subcommittee, I am pleased to have the opportunity to discuss S. 1787, a bill that would establish a tax credit for purchases of commercial property from the Resolution Trust Corporation (RTC). The Congressional Budget Office's (CBO's) analysis of this proposal reaches the following three conclusions:

- The credit would increase the resolution costs of the savings and loan debacle;
- The credit would not increase sales of RTC property; and
- The credit would not increase local commercial property values.

Let me begin with a brief description of the salient aspects of the proposed credit. It would apply to sales of RTC commercial property sold in 1992 and 1993. The total value of the credits would be capped at $1 billion. In each case, the RTC would set the value of the credit made available to the buyer to equal the minimum amount needed to sell the property. Under S. 1787, the present value of the credit cannot exceed 80 percent of the purchase price of the property plus necessary rehabilitation and completion costs. The buyer must use the tax credit in five equal annual installments, beginning with the year of purchase. The amount of the credit would not reduce the depreciable basis of the purchased property.

Moreover, the credit would be subject to limits on the amount that could reduce a taxpayer's total tax liability. For corporations, the credit generally could reduce total tax liability by no more than $25,000 plus 75 percent of the tax otherwise owed in excess of $25,000, under the rules covering general business credits. Credits that are limited in this way could be carried forward and used in future years. If the buyer subsequently sold the property, the buyer would pay 20 percent of any profits realized to the RTC, in addition to any capital gains taxes that would be due to the IRS.

ANALYZING THE PROPOSED CREDIT

CBO's analysis focuses on how the credit would affect the resolution cost of the savings and loan insolvencies as well as what its likely effect would be on sales of RTC property and on the value of commercial real estate. To examine these effects of the credit, one needs to specify the base case policy against which the credit should be compared.

CBO has concluded that the credit should be compared with the alternative of the RTC lowering the prices of the properties sufficiently to ensure that they are sold. This base case for comparison is different from the one used in the GRC Economics study, *Economic Implications of a Tax Credit Program to Facilitate the Sale of RTC Property*. That study compared the tax credit with a policy in which the RTC held onto the properties, trying to sell them at unrealistically high prices. Unfortunately, that study's analysis is flawed because such holding costs are avoidable under current law. The RTC currently has the authority to reduce prices directly in response to local market conditions, and it has in fact exercised this authority.

The Costs of Resolution

The tax credit would affect the timing and value of receipts to the Treasury and the RTC. The sales prices of properties sold with the credit would be higher than in the base case because the buyers would be willing to pay for the tax benefit. This higher amount of receipts would flow to the RTC immediately upon sale of the properties in 1992 and 1993. Because these receipts would be classified as offsetting collections in the Federal budget, Federal spending would decline immediately.

However, the cost of resolution must also take account of the revenue loss associated with the tax credits. Tax receipts would be reduced over the 5 years in which the credit would be distributed. In this way, the RTC's net outlays would be reduced quickly, but the Treasury would experience a long-term revenue loss. Because the effects of sales under the credit alternative would stretch over a 5-year period while those of the base case would occur in a single year, it is appropriate to compare the costs of resolution under the two alternatives on a present value basis.

Under certain extreme circumstances, tax credits and lower prices could result in the same sales at the same cost to the government. This result would take place if a credit that costs the same as a lower price has the same value to potential buyers. A potential buyer would, for example, equally value a guaranteed tax credit with a present discounted value of one dollar and a one dollar reduction in the price of the property.

In practice, the alternatives are not equal because the buyers would take into account both the riskiness of the credits and the difference between their own discount rates and the Federal government's. Both of these differences would make buyers require a premium of credits over direct price reduction. Several reasons account for this. First, buyers would bear much risk with this tax credit from unexpected changes in net income and tax law. For example, buyers might unexpectedly find themselves with no tax liability against which to use the credit, or they might be constrained by the limits on the use of the credit. In addition, the credit might be repealed before the buyers are able to use all of their credits 5 years down the road. Second, the buyers would have a higher discount rate than the Federal government, since they face a higher cost of funds.

In addition, a limited pool of potential buyers under the credit alternative would contribute to a lower after-tax price paid by the buyer than in the base case. Since not all potential buyers would be able to take advantage of the proposed tax credit, the RTC's potential market for selling these properties would be restricted. Some potential buyers are nonprofit institutions that are exempt from the corporate tax, while others may be unprofitable and therefore unable to use the tax credit.

These factors lead to the conclusion that it would be more costly for the government to sell the properties with the credit than to sell them at a lower price without the credit. Use of the credit would increase the costs of resolving the insolvent savings and loans on a present-value basis, even after taking into account the higher immediate receipts by the RTC from the higher sales prices. In other words, the present value of the revenue loss from the credits would exceed the present value of the increase in RTC receipts. In this way, the tax credit would be similar in effect to the Federal Savings and Loan Insurance Corporation's use of tax benefits to finance pre-1989 resolutions of insolvent savings and loans.

The proposal's profit-sharing component does not alter this conclusion. Under the proposal, if the buyer resells the property, the RTC receives 20 percent of the realized gain on the property. The buyer would treat this profit-sharing arrangement no differently than the income tax on the gain from the sale of capital assets. The buyer would know that the potential return to the property would be reduced upon sale, and the buyer would incorporate this knowledge into the bid price for the property. If anything, the potential buyer would require even more tax credits as reimbursement for the tax on the return to risk.

Effects on Sales of RTC Property and Prices of Other Commercial Property

CBO concludes that the proposed credit would not increase sales of RTC property above the amount of sales in the base case. After all, any property that the RTC could sell with the credit could be sold as easily in the base case with an even smaller direct price reduction. The investors who make their money available to buy the property would surely understand the advantages of the direct price reduction over the credit. As a result, we would expect the availability of this tax credit not to spark any increase in buyers' interest in the RTC properties.

We also conclude that the proposed credit would not act to prop up local commercial property values because the underlying rental value of the properties would not be affected. The after-tax price that buyers would be willing to pay for a property depends on the after-tax cash flow and the discount rate. In turn, the after-tax cash flow depends on the rents that can be earned from the property. Because the underlying supply of properties would be unchanged, the tax credit would not affect the rents for both these RTC properties and other, competing properties. Thus, the credit would not affect the after-tax prices of the RTC properties and competing properties. The proposed credit would raise the price of only the affected RTC properties because the buyers would be willing to pay specifically for the tax subsidy. The credit would not change the prices of commercial properties in general, which would remain depressed from the overbuilding of the past decade—a development that is apparent in today's high commercial vacancy rate of nearly 20 percent.

Viewed in a different way, the credit would not affect potential buyers of competing commercial property because they would "see through" the higher nominal sales price on RTC properties that included a tax benefit. True, sale of RTC property with a credit would be recorded at a higher selling price. Potential buyers in the general real estate market would have no reason, however, to offer higher prices for properties that do not have the same associated tax benefit.

In summary, S. 1787 would be expected to increase the resolution costs of the savings and loan debacle on a present discounted basis without stimulating sales of RTC properties or improving conditions in the local real estate markets.

Prepared Statement of Representative Thomas J. Ridge

Thank you for having me appear today. I want to say first that the RTC has been slowly improving its operations. Let's be fair to give credit where it is due. Asset sales are moving forward. But I can also say without fear of contradiction that the most difficult sales lie ahead; the agency has sold the most liquid assets first, and still has many billions of dollars of liquid assets on its books. specifically, the RTC has $100 billion in hard-to-sell assets, almost two-thirds of its inventory.

Because of the slow pace of sales and the ever-higher cost of thrift resolutions, voter antipathy toward the RTC and the bailout remains high. The House Banking Committee has adopted some reforms, including a more streamlined oversight and management process, but selling liquid assets is a job that will test the most energetic, creative realtor. And you know what the national market looks like right now. The Banking Committee is as frustrated as the average taxpayer. This stuff has got to be moved. But we need better tools that will assist the RTC without disrupting the progress made to date.

Mr. Frank and I will offer the RTC tax credit at the full Banking Committee markup this month. It would take $1 billion of the $80 billion and allocate it over 5 years to investors putting equity into hard-to-sell projects. It would greatly speed the sale of hard-to-sell assets, thus reducing expensive holding costs. Due to other benefits it would ultimately reduce the cost of the bailout.

I want to stop, though, and say this: we know we need the blessing of the senate Finance and the House Ways and Means Committees. As a member from a Committee whose jurisdiction is currently under attack by a sister Committee, I have no intention of pushing this in anyone's face. Although the money would come from the S&L funds, we would need implementing language from the tax committees.

Mr. Chairman, what is the advantage of a tax credit for the RTC property?

Traditional sources of equity just aren't there. The real estate people with the deep pockets are paying off existing debt, if they're still in business. The pension funds and insurance companies are justifiably nervous. Let's face it, it's hard enough to even come up with any financing in this environment, never mind equity.

But syndication opens up nontraditional sources of equity, the smaller-scale investor, some of them at the median household income of the United States, who put in small amounts of money for a piece of the tax credit. By some accounts, there are 80,000 of them out there, and they are ready to invest. This is the secret of the idea: we need these investors to invest in RTC property. They can't right now.

Another advantage of this proposal is the opportunity for the government to profit "on the upside" in cases where the real estate increases in value. While none of us anticipate the returns of the early 1980s, it is fair to say that the middle-range trend is for the property to increase in value once the overage is worked off and the Nation comes out from under its debt cloud. Currently, many, although not all, of the RTC's sales have no upside gain for the government. In some cases there is only downside risk, if the property goes into default again and comes back to the government.

For those of you from the Southwest or the Northeast, there is another advantage, a much more subtle one: the tax credit prevents a negative spillover effect on nearby neighborhoods. The government can sell property by severely discounting it. We all know this. But this action contributes to the devaluation of neighboring property, perpetuating an awful trend of price spiralling, which in turn affects thrifts and banks trying to keep their heads above water. The tax credit brings money up front for a higher purchase price, bringing some degree of stability to the neighborhood. Take it from a Banking Committee member: we don't need more negative spillover effects dragging down more institutions.

The bottom line is this: by accessing more investors, by increasing the supply of equity, the tax credit will move more property at a higher price than existing methods of sale. And the speed of this movement will save money from reduced holding and deterioration costs.

Mr. Chairman and members of the Committee, there are no easy solutions to the RTC dilemma. This idea has as much merit as any; I believe it will begin to move property in markets where the credit crunch and the oversupply of commercial space has resulted in an absolute halt to commerce. I thank you for having me appear today. I hope to work with you to make this idea a reality.

PREPARED STATEMENT OF JOHN M. URBANCHUK

Good Afternoon, my name is John M. Urbanchuk and I am a Vice President with AUS Consultants, a Philadelphia based economic and management consulting company. I am pleased to appear before the committee this afternoon to discuss the potential benefits the economy would realize from implementation and operation of a tax credit program designed to facilitate the sale of property held by the Resolution Trust Corporation (RTC) and the Federal Deposit Insurance Corporation (FDIC). Reflecting this design, we have called our tax credit the Asset Disposition and Revitalization Credit, or ADR Credit in short.

The amount of property held by the RTC and FDIC continues to escalate as the economy languishes through an unprecedented sluggish recovery. Consumers and investors are showing themselves to be reluctant to respond to lower interest rates, seeming to react instead to deteriorating real incomes and weak consumer confidence. There are also significant regional disparities in economic recovery with regions most heavily dependent on the services, finance, insurance and real estate industries still sluggish. It is not surprising that the bulk of RTC and FDIC property is concentrated in these areas: the west, south-west, selected southern states, and the northeast.

The costs associated with acquiring property by the RTC and FDIC are escalating, so too are the costs associated with carrying and maintaining property in inventory. The government is not in the business of maintaining and operating commercial property, and the RTC and FDIC does not have the staff or capabilities to match a private sector manager with a market-determined profit incentive. As a result the value to the troubled assets held by the RTC and FDIC can be expected to decline as long as they remain in government hands.

Mr. Chairman, I want to make one point here in direct rebuttal to an argument of Dr. Reischauer, the Director of the Congressional Budget Office, in his testimony. He cites the study I did last year about the ADR Credit. He says:

> That study compared the tax credit with a policy in which the RTC held onto the properties, trying to sell them at unrealistically high prices. Unfortunately, that study's analysis is flawed because such holding costs are avoidable under current law. The RTC currently has the authority to reduce prices directly in response to local market conditions, and it has in fact exercised this authority.

I regret that the Director is not familiar with the restrictions that are specifically in the law to restrict the RTC from cutting the prices of properties to a market-clearing level in distressed areas. [Section 501 (b)12(D)–1E) of P.L. 101–73] These restrictions were put into the law specifically because Congress was worried about the surplus property being dumped into the market. I think this lack of attention to the specific details of the current market situation and the general, theoretical economic model of pricing, which Dr. Reischauer's staff have relied upon, is what differentiates my remarks today from his.

The RTC and FDIC has been conducting auctions to sell off real estate holdings, but potential investors have been slow to respond. What is needed is an economic incentive to induce private investors to come forth and acquire RTC and FDIC property. We feel the ADR Credit is just such a vehicle. Tax credits were created by Congress to provide an incentive for investment in sectors of the economy deemed in the national interest. Examples of tax credits programs include the Re- search and Development Credit enacted in 1981 to induce private sector investment in R&D, and the Low Income Housing Credit created in 1986 to encourage the construction of low-income rental housing.

It is important to look for a moment at the economic effect of these tax credits, in comparison with the proposed ADR credit. The main difference between the other tax credits and the ADR credit is that the ADR credit is not an entitlement. It is a finite sum that is fixed in advance by the Congress. Its budget impact is specifically limited to the sum Congress allows. In this way, it has a so-called revenue impact that is not variable or subject to any uncertainty in estimation, except perhaps to the degree that not all of the allowed aggregate credit is used by the RTC or FDIC. In some respects, this particular "tax expenditure" behaves in a predictable way as do direct dollar outlay expenditures.

The main similarity of the ADR credit with the other tax credits is that it can be passed directly through to the ultimate investor in the property. The alternative of cutting the direct sales price of a property does not carry with It any distributional implications. As in the case of the Low Income Housing credit, experience with the program has demonstrated that the credit itself attracts investor interest in a way that the underlying value of the property itself would not. To argue that the credit is identical to cutting the price is to assume that any limited partnership formed for the purpose of acquiring this property has an identical set of motivations by the general partner and the limited partners. This is not the case.

One important feature of the Asset Disposition and Revitalization credit is that it would bring in new money to the real estate sector. Bank financing is very hard to obtain today for these assets. The ADR credit would mobilize non-bank financing. The ADR credit focuses investment capital in the market specifically on the kinds of assets that carry the credit. In a perfect capital market, all assets with the same degree of risk would have the same rate of return. The ADR credit gives the investor a higher after-tax rate of return, so the RTC and FDIC properties are more attractive than without the credit. The effect this has on the price of the assets is exactly symmetrical—they will sell for a higher price, based on the rental incomes they can produce. A given amount of rents paid will have a higher after tax value to the investor than without the credit.

The ADR Credit will have important economic benefits by preventing additional deterioration of local real estate markets. RTC and FDIC property holdings are highly concentrated in economically depressed areas. As the RTC and FDIC lowers the market (recorded transaction) price of distressed properties in an attempt to reach a market clearing price, the value of surrounding real estate also tends to fall. This not only undercuts all property values, but further deteriorates the quality of portfolios of financial institutions. It also undermines confidence, of lenders, borrowers, investors, and consumers.

The ADR Credit essentially results in reducing the market price of the property by the amount of the credit, but importantly it does not affect the recorded transaction price. As a result, the value of surrounding property—particularly if it is economically viable, or performing—should not be affected as directly as a wholesale cut in market values.

In his testimony the Director of the Congressional Budget Office has argued that the overall market values of the properties in a locality cannot be "propped up" by the existence of the ADR Credit because the market values are determined strictly by the capitalized values of the after tax rents. Because the ADR credit does not change the number of properties, the letter says, it cannot "prop up" the market values. He does agree, however, that the prices of properties held by the RTC and FDIC would be increased, because investors would be bidding for the ADR credits.

There is an unfortunate confusion here between the idea of halting a continuing decline in real estate values, due to the pressure on the market from a large inventory of vacant real estate and the tightening of credit resources due to the declining asset values. I don't think anyone has argued that the APR Credit is a device to *increase real estate values in general.* On the contrary, the purpose of the APR Credit would be only to increase the sales prices of RTC and FDIC properties by attracting new financing from non-bank sources. Indeed, on the last page of his testimony, Dr. Reischauer says, and I quote: "True, sale of RTC property with a credit would be recorded at a higher selling price." I am sure that every bank and other institution that must rely on the recorded selling price of real estate as either a direct measure of its value, or an indirect measure as comparable properties are recorded, will see this result of the APR credit as a very positive benefit.

The testimony from Dr. Reischauer further makes the case that the tax credit would be seen by any potential investor *as inferior* to a direct cut in the price of the property, because "buyers would bear much risk with this tax credit from unexpected changes in net income and tax law." I want to make two points: first, in the case of the Low Income Housing Tax Credit, the investors do not seem to treat the credit as a risky thing, but as a government guarantee of some yield from the investment. Investors know what their income from other sources is expected to be, and they evaluate the Low Income Housing Tax Credit as something that enhances the after-tax value of that income. So I think there is not a genuine risk from absence of taxable income in this analysis. Second, the risk that the Congress will repeal the tax credit may theoretically exist, but for a two-year program think that risk is quite small. Moreover, the other tax credits we are modelling the ADR Credit on do not suffer from this perception in the market. I think the Congressional Budget Office is concerned with a non-existent problem today, although in the year 1986 and 1987 it might have existed. Once granted, the tax credit would become a right attached to ownership of the property. Congress would not constitutionally be able to take away a specific credit, even though it could discontinue the ADR Credit in respect to future sales of RTC or FDIC property.

We believe the ADR Credit will assist the RTC and FDIC to sell property more quickly and at a higher price than would otherwise be the case. Clearly the RTC and the FDIC need some help in this market because the tools that have been given to them by Congress heretofore have not been adequate. Something else needs to be done.

Specifically, the ADR Credit will:

- Save taxpayers money, stimulate the economy, generate both personal income and additional tax revenue, and create jobs.
- Generate almost $2 in revenue for the RTC and FDIC for every $1 of tax credit extended.
- Reduce holding costs for the RTC and FDIC and provide a larger stream of revenue to fund RTC and FDIC operations thereby reducing borrowing and interest expenses.

Just as a comment on Dr. Reischauer's use of present value analysis to reach the conclusion on page 4 of his testimony that buyers would require larger dollar amounts of ADR Credits than they would require as direct price cuts, I would note that he compares the government's borrowing costs with the investors' borrowing costs. Because the government's borrowing costs are theoretically lower, he assigns a greater present value to the option of holding the property in inventory than to selling it with an ADR Credit attached. I have two problems with that analysis. First, he earlier criticized my own use of this alternative. He said the true alternative was between cutting the price versus holding the property. Then he argues in favor of holding the property because the government can borrow at a cheaper rate than a private investor. If the lower interest rate on Treasury Bonds is the determining factor, then the answer is easy: Congress should just let the RTC and FDIC keep its inventory, and let the taxpayers simply pay interest on the bonds.

Our analysis of the ADR credit, however, is based on the idea that the government is a very poor custodian of all this real estate. Putting it back into the private sector is the way to get the real economic value out of it. If privatization is what we are telling the Eastern Europeans and the U.S.S.R. to hurry up and do, why shouldn't we enact measures to do the same thing in America with all this commercial real estate?

In order to evaluate the economic costs and benefits of the ADR we analyzed a $1 billion tax credit that would be authorized at $500 per year over a 2 year period, each spread over 5 years. The net present value of this credit at a 9 percent discount rate is $684 million. An 80 percent tax credit would facilitate the sale of $ 1.25 billion of RTC and FDIC property which would have a present value of $1.1 billion. Subtracting the cost of the credit ($684 million) from the present value of the revenue stream ($1.1 billion) provides a positive value of $41 5 million. By comparison, if the RTC and FDIC were to hold onto the $ 1.25 billion of property and sell it at the end of the 5 years, the net present value of the revenue stream from the eventual sale, adjusted for holding costs of approximately nine percent (5 percent for maintenance and 4 percent for insurance), is only $239 million. This provides a benefit of almost $2 of revenue for every $1 of tax credit extended.

The reasons for this conclusion are straightforward: the costs of holding on to the property (repair, maintenance, lost taxes, insurance, and economic depreciation) exceed the cost of the tax credits, especially when the time value of money is considered. Simply put, selling the property as quickly as possible at or near its appraised value is preferable to holding onto a depreciating asset, even when the future costs of the tax are considered. We believe that the ADR Credit will be an effective economic incentive to attract capital to this market that would otherwise not be available.

There are likely to be additional important economic implications from the use of the ADR Credit. As properties are returned to the private sector and brought into the economic mainstream by private investors they will generate output, incomes, and jobs. This output and income will, in turn, generate additional tax revenue for both federal and state treasuries. These benefits will help offset the direct costs associated with the foregone tax revenue experienced by the Treasury caused by the tax credit.

Will the ADR Credit work? Will it provide an adequate economic inducement to entice private investors to acquire RTC and FDIC property? We do know that RTC and FDIC efforts to cut prices on property have been at best marginally successful. We also know that tax credit programs have been successful attracting private investment capital in the past.

We are suggesting a test program of $1 billion with $500 million authorized in the first year and $500 million in the second year. If the ADR Credit turns out to be successful, it can be readily expanded. If the credit does not work, the cost to find out is limited.

One last thought. Recently there has been a great deal of talk about the need for fiscal stimulus to jump start the economy. A cut in the capital gains tax, relief for first-time home buyers, and income tax cuts for low and middle income wage earners are among the remedies being discussed by both parties. Regardless of the initiative, some positive action is necessary to restore confidence in consumers and investors. We feel the ADR Credit would be a cost effective step in the right direction.

Attached to my testimony, I would like to submit for the record an analysis prepared by Joe Cobb, former Minority Staff Director of the Congressional Joint Economic Committee, of the effects of two theoretical cases: the case of "moving along a demand schedule," which is essentially the logical model that opponents of the ADR Credit rely.

APPENDIX: THE USE OF TARGETED CREDITS TO STIMULATE DEMAND

[Joe Cobb, Economic Consultant]

INCREASING TOTAL DEMAND

In any market for assets with a relatively close substitutability, the number of units sold is going to depend on the price of the marginal, or most recent, unit sold or the next unit to be sold. The validity of this concept, however, rests on the temporary assumption that the demand for the assets at any point in time is a real function of the number of investors or buyers in the market, as well as the number of assets and their prices.

In looking at the market, it is very important to understand two kinds of changes that might occur in order to change the number of assets sold—or the price at which those assets will sell. The first kind of change stays with the assumption that the total demand is unchanged. The number demanded depends on cutting the price. The second kind of change relaxes the assumption of unchanged demand and looks at what could make the demand greater. With a greater demand, both the prices at which assets sell and the total number of assets would be greater.

The Asset Disposition and Revitalization tax credit is exactly the kind of incentive that would cause an increase in the level of the demand for the assets to which it is applied. It would also have the effect of increasing the demand for those particular assets without necessarily reducing the demand for other, similar assets that do not enjoy the special credit. This is because the level of demand is enlarged for the favored assets without fully shifting the demand away from assets that do not enjoy the credit.

First, we must remember that economic demand is not a fixed pie. Some things make it larger, just as some things make it smaller. The entire universe of investment opportunities must be considered not just real estate investments. The argument that providing the ADR credit to RTC and FDIC properties might cause sales to be reduced for other properties in a local community that do not enjoy a similar credit *is false because* the assumption is made that demand would not be increased by the credit. If you assume a pie is fixed in size, increasing one slice must reduce the size of its neighbors. But if you enlarge the pie, the effect on other slices need not be reduced. They could even be enlarged.

One important feature of the Asset Disposition and Revitalization credit is that it would bring in new money to the real estate sector. Bank financing is very hard to obtain today for these assets. The ADR credit would mobilize non-bank financing.

This is one of the most robust features of the ADR credit, and one of the main reason it would increase overall demand for real estate assets instead; acting as an unfair competitive advantage for the government's inventory of properties.

Today, "real estate" is in bad repute. Investors are not interested—particularly when the stock market looks like the next big mover. The ADR credit would be very useful in creating new "buyer interest" in RTC and FDIC assets. An increase in buyer interest, in turn, would stimulate demand and bring in higher prices generally for RTC and FDIC properties. This is the strength of the syndication feature the ADR credit would introduce.

Indeed, today the real estate market in some locations is very depressed because of the *expectations prices must be cut* in order to sell the properties. Rational investors will wait until the prices are cut, instead of buying today. Adoption of the credit will send a signal to the real estate market that price cutting will not occur, and demand will return to normal faster than it otherwise might.

PRESENT VALUE UNDER VARIOUS ASSUMPTIONS:

(1) holding the properties at their current book value and selling them, less depreciation, whenever someone eventually wanted to buy;

(2) cutting the price today until a buyer would be willing to take the property; and

(3) providing the buyer with the ADR credit.

Choices (1) and (2) are identical in terms of net present value if the price cuts in option (2) were exactly equal to the assumed interest rate in the formula used to discount the assumed future value (1) of the property (assumption: book value, less depreciation). However, the book value of a property, less depreciation, has *no current or future* economic meaning. It is based on construction and appraisal costs from last year or several years ago. There is no reason to believe a true economic value of the property "in the future" can be based on it.

More important, the "present value" of the property is always its current market price—*assuming we have a buyer*. In the depressed market today, the present value based on price cutting will be much lower than under market conditions later in the economic recovery, but we do not know when the market conditions will improve. The most important detail is to stimulate buyers' interest.

Choices (2) and (3) are identical in terms of net present value only if you assume that the correct rate of discount, which is used to compute net present value, is equal to the rate of tax savings by anyone who would become entitled to the ADR credit. Although it is a mathematical identity for the government, and revenue neutral (the present value of the tax expenditure is a dollar-for-dollar substitute for any lowered price necessary to make the sale without.a tax credit), it is not a mathematical identity where it counts! The assumption is very difficult to justify on the *demand side* of the market, where the investors must be found.

The dynamic impact of the Asset Disposition and Revitalization credit is far more powerful than the net present value financial analysis can demonstrate. The real power of the ADR credit will be its results in making RTC and FDIC assets look less like dogs and more like ponies in the market. Business analysts who want the Federal Reserve System to lower interest rates in order to "stimulate" the economy have not looked at the main reason why the economy has slowed down. The *over investment* in real estate in the 1980s has "locked up" too much capital. Our choice today to "unlock" that capital is: (1) to stimulate the demand for the capital that is in excess supply, or (2) stimulate the demand for all capital—by lowering interest rates. The second option has gone as far as the Federal Reserve can allow without going over the edge into inflationary pressures.

REDUCING THE NEED FOR WORKING CAPITAL

Because the Asset Disposition and Revitalization credit has the potential to "turn over" the RTC and FDIC property inventory more rapidly than would happen without it, the credit increases the "liquidity" of the assets, by making them more marketable. The *working capital* needs of the RTC and FDIC become smaller if the turn-over of the fixed capital occurs at a faster rate. The U.S. government has to pay interest on the working capital, just as it has to pay interest on the fixed capital that is tied up in properties nobody wants to buy. The numbers here are difficult to specify, but the fact that there is a *real savings* is beyond dispute.

Giving up a dollar in price is equal to giving up a dollar in tax revenue, to the government, but to the buyer of a property it looks very different. The price they pay becomes part of the cost basis of the property, and therefore it can be used for leverage financing, both now and upon refinancing; it becomes the starting point for calculating the yield on the investment; it becomes the starting point for the calculation of depreciation for both tax and financial accounting purposes. The ADR credit, on the other hand, is a fixed value, which the buyer can count on for application against his consolidated tax liability for five years into the future. The buyer of a property with an ADR credit is getting *two* values, a fixed value in the ADR credit, and a speculative value in the property. The speculative value in the property, moreover, is higher in precisely the way the buyer would want it to be—in the form of a higher cost basis.

COMMUNICATIONS

AMERICAN BANKERS ASSOCIATION,
Washington, DC, October 25, 1991.

Hon. DAVID BOREN, *Chairman,*
Senate Finance Subcommittee on Taxation,
U.S. Senate,
Washington, DC.

RE: S. 1787, to encourage sale of real property held by the Resolution Trust Corporation by allowing a tax credit

Dear Mr. Chairman: I am writing to present the view of the American Bankers Association (ABA) on S. 1787, legislation introduced by senator Breaux to encourage the sale of real property held by the Resolution Trust Corporation by allowing a credit against income tax to purchasers of such property. The ABA is opposed to this legislation. The ABA is the national trade and professional organization for America's commercial banks. The members of the ABA range in size from the smallest to the largest banks, with 85 percent of our members having assets of less than $100 million. Assets of our members comprise over 90 percent of the total assets of the commercial banking industry.

The Nation's banks have a vital interest in restoring health to the real estate industry as commercial banks hold $848 billion of real estate loans. The industry also holds more than $24 billion in real estate as a result of foreclosures. We believe that a broad based approach is the best means to address the decline in real estate values until demand again catches up with the oversupply of commercial properties.

Bankers in markets saturated with RTC held property agree with Senator Breaux that RTC ownership is not a positive influence on the local real estate market or on the local economy, but they feel strongly that a tax credit targeted to purchases of RTC property will do more harm than good in those markets. Targeted tax credits will raise the value of those properties subject to the credit, and drive down the value of neighboring properties that do not give purchasers the benefit of a tax credit. Purchasers will discount the value of non-credit properties to reflect the fact that they will not have the same credit-enhanced after tax income as the properties benefiting from the credit. The effect will be to reduce the value of foreclosed properties held by banks and others and the value of the local real estate market generally.

Providing a credit for only certain properties will discriminate against buyers of foreclosed property currently held by banks or non-credit property held by the RTC because it will produce different tax burdens for similarly situated buyers. Purchasers of credit-eligible property could receive tax savings that exceed the property's purchase price through use of the credit and depreciation deductions. This will distort the market to increase demand for the credit enhanced property, but decrease demand for non-credit properties.

Mr. Chairman, the best solution to the problem is a broad based solution that stabilizes the value of real property for all holders and purchasers. Thank you for your consideration of our views.

Respectfully,

HENRY RUEMPLER.

STATEMENT OF GRC ECONOMICS

The timely sale of real property held by the Resolution Trust corporation (RTC) expedited by a tax credit program will save taxpayers money, stimulate the economy, generate both personal income and additional tax revenue, and create jobs. Compared to the alternative of the RTC holding property in inventory for eventual sale, this tax credit is expected to generate almost $2 in revenue for the RTC for every $1 of tax credit extended by the U.S. Treasury. This revenue will help the RTC finance current operations and reduce required borrowings.

INTRODUCTION

The cost of the savings and loan industry bailout by the Federal government continues to grow at a seemingly exponential rate. Estimates of the cost to the taxpayer for the bailout made less than a year ago of a "few" billion dollars have mushroomed to upwards of $500 billion. The Resolution Trust Corporation (RTC) was formed in 1989 as an independent Federal agency to facilitate the rescue and reorganization of insolvent S&L institutions.

The RTC was originally funded by a congressional appropriation and the current inventory of property is financed through issuing government-backed securities in the private capital markets. The RTC plans to fund future operations through a combination of borrowings and proceeds from the sale of properties to the private sector.

A major element of the cost of the bailout process is the acquisition and disposition of real assets of insolvent institutions. At the end of April 1990 the RTC held title to 37,082 properties with a book value of $13.9 billion. Commercial and multi-family properties account for 12 percent of the total number and 42% of the value of RTC holdings. It is widely believed that the vast majority of these properties are economically distressed because of location, condition, or stage of completion.

The government is not in the business of maintaining and operating commercial property, and the RTC does not have the staff or capabilities to match a private sector manager with a market-determined profit incentive. As a result, the value of these troubled assets can be expected to decline over time as long as they remain in government hands. If this is the case, the following questions then arise:

- How likely will a sale occur at a price close to the current appraised value?
- How quickly will the sale occur?
- How much does it cost the RTC to hold property?
- What can be done to facilitate the timely sale of RTC property?
- What are the costs and benefits to the taxpayer of the RTC holding property versus sale?

The purpose of this study is to evaluate the economic costs and benefits of a tax credit program designed to facilitate the sale of RTC property. A tax credit is a dollar for dollar reduction of taxes due. Tax credits were created by Congress to provide an incentive for investment in sectors of the economy deemed in the national interest. Examples of tax credit programs include the Research and Development credit enacted in 1981 to induce private sector investment in R&D, and the Low-Income Housing Credit created in 1986 to encourage the construction of low-income rental housing.

This study was prepared by CRC Economics under the direction of John M. Urbanchuk. CRC Economics is the Washington-based economics consulting unit of Hill and Knowlton, Inc.

THE RTC CREDIT

The objective of the RTC Credit is to provide an incentive for expediting the sale of RTC property to the private sector thereby reducing the long-term cost of the savings and loan crisis to the taxpayer. The RTC Credit would be allocated at the discretion of the RTC or some other Federal government agency and will not be available for use on those properties that could be sold at or near market value. Specific characteristics of the RTC Credit include:

- The RTC Credit would be a tax credit of up to 80 percent of the appraised value for the acquisition of property owned by the RTC.
- The credit would be limited to the amount determined to be necessary in light of other sources of financing to provide the RTC with the selling price it desires.
- Funds generated by the credit would be paid directly to the RTC.
- The credit period is for 5 years beginning with the taxable year in which the property is purchased and would be earned in five equal annual installments.
- Congress annually would authorize a dollar limit for the RTC Credit.
- The RTC would have to show that it exercised reasonable efforts to sell property in inventory at or near appraised value. In the event that reasonable efforts fail to

sell at this price within a reasonable period of time (e.g. 6 months), the RTC shall certify that the property could not sell but for the inclusion of the credit.

- Ownership of the property purchased by a private taxpayer under the credit must be maintained for a period of 5 years. Sale of property before the end of the credit period would not trigger recapture but would cause the cessation of any further tax benefits.
- RTC credits may be used to offset the lesser of $50,000 or 50 percent of tax liability for individuals. For corporations, the credit would be subject to the rules of the general business credit including the maximum amount of income tax liability that may be reduced by a general business credit for any 1 year ($25,000 plus 75 percent of the remaining tax credit).
- The RTC Credit will not be considered a preference item under the Alternative Minimum Tax (AMT) and may not be used to offset tax due and owed under an AMT calculation.

ECONOMIC IMPLICATIONS OF THE RTC CREDIT

The immediate sale of RTC property expedited by a tax credit is clearly preferable to the alternative of holding the property by the RTC. In order to assess the economic costs and benefits of the RTC Credit, we have assumed a $1 billion tax credit that would be authorized at $500 million per year over a 2 year period, each spread over 5 years. The net present value (NPV) of the cost of this tax credit at a 9 percent discount rate is $684 million.

An 80 percent tax credit of this size would facilitate the sale of $1.25 billion of RTC property, providing the RTC with this amount of money which can be used to fund operations and reduce borrowing requirements. The present value of this revenue stream is $1.1 billion. When the $684 million cost to the Treasury is subtracted from the value of the revenue stream, the RTC Credit has a positive net present value of $415 million.

On the other hand, if the government were to hold on to $1.25 billion of property and sell at the end of 5 years, the net present value of the revenue from the sale, adjusted for holding costs, is only $ 239 million.

Under this analysis the benefit of selling RTC property with the RTC Credit is almost 2:1 compared with the alternative of holding property for sale at a later date.

The reasons for this conclusion are straightforward: the costs of holding onto the property (repair, maintenance, lost taxes, insurance and the economic depreciation incurred by the idle property) exceed the cost of the tax credits, especially when the time value of money is considered. Simply put, selling the property now at its appraised value is preferable to holding onto a depreciating asset, even when the future costs of the tax credits are considered.

MACROECONOMIC IMPLICATIONS

Use of the RTC Credit likely will create significant potential economic benefits through the rehabilitation of RTC properties and transfer to the productive private sector. As properties are returned to the private sector and brought into the economic mainstream by private investors they will generate output, income and jobs. This output and income will, in turn, generate additional tax revenue for the Federal Treasury and increased revenue for the States in which they are located. These benefits will help offset the costs associated with the foregone tax revenue experienced by the Treasury caused by the tax credit.

Since there is little information available about the "quality" and economic status of RTC properties (how many are occupied and at what rates, or are idle) we have estimated the potential economic benefits of the RTC Credit option by making some simple assumptions; utilizing information gleaned from RTC records; and applying these to regional impact multipliers maintained by the Department of Commerce's Bureau of Economic Analysis. Assuming that half of the RTC property is currently economically idle, our analysis indicates that:

- The privatization of $1.25 billion worth of RTC property would add about $325 million annually to GNP.
- Household income would increase $130 million per year generating $30 million per year of new Federal tax revenue.
- Over 4,000 new jobs would be created.

The RTC held commercial property worth almost $7 billion as of April 30, 1990. The majority of this property was accounted for by commercial office space (27%), multi-family housing units (26%), retail real estate (16%), and other commercial real estate (13%). The remainder of properties were hotels and motels, golf courses and other recreational facilities, nursing homes, and industrial parks. Based on RTC data, it is virtually impossible to determine how much of the RTC property is occupied and operating and, if operating, at what capacity. Further, it is difficult to estimate how much revenue this property would generate on an annual basis.

In order to estimate potential economic implications, we applied several key assumptions to the RTC property data by state, namely:

- An assumption that 50 percent of the RTC property is currently in occupied and generating some economic return.
- An assumption that RTC commercial properties would generate rental income of $0.25 per $1.00 of market value. This assumption was based on data provided by the Building Owners and Managers Association (BOMA).

NET PRESENT VALUE CASH FLOW ANALYSIS

The economic implications of the RTC Credit were evaluated by comparing two alternatives available to the government vis-a-vis RTC property. There is a continuous set of sale alternatives available for analysis. However to set a high and low band on these in the context of a 5 year tax credit, we analyzed the following alternatives:

- **an immediate sale at appraised value, combined with an 80 percent tax credit spread over & 6-year period.** This results in a positive cash flow to the RTC immediately (year 0), followed by negative flows over the next 6 years, representing the loss of revenue by the government.
- **retention of the property by the RTC over the same 5-year period, with a sale at the end of the period.** This results in no cash inflow immediately, negative flows in the intervening years, due to maintenance, local taxes, and insurance, and a reduced Positive flow in year five, representing the depreciated value of the property net of the fifth year maintenance costs.

There are two polar cases. Clearly the RTC can sell the property earlier than 5 years or hold it longer than 5 years. An analysis of the full range of alternatives indicates that the RTC Credit is most effective for property held between 3 and 4 years. After the seventh year, the holding costs to the RTC become so great that the government would make money by giving the property away.

Considering this, the major question becomes how likely is the RTC to sell its portfolio of property within a 48 month period? The sheer scale of RTC's holdings ($13 billion at the end of April 1990), would argue that a dumping of property at any price would further depress seriously stressed real estate markets. This not only would erode the value of RTC property, but of all other real estate as well, thereby forcing additional thrifts and commercial banks into insolvency.

The methodology used to estimate the costs and benefits of the tax credit was discounted cash flow analysis. This technique applies a discounting factor to future cash flows to reflect the cost of funds and the preference for a dollar today versus a dollar in the future. This discount factor represents the opportunity cost of funds, which in this case is the cost of funds to the Federal government.

DATA SOURCES

Data on the government's cost of money, the cost of holding onto the foreclosed property, and true economic depreciation over time was necessary to the analysis. Among sources used for this information:

- The government's cost of money was based on the true effective yields currently prevailing on the RTC 30- and 40-year bonds recently auctioned. This yield is currently around 9 percent.
- Holding cost calculations came from the 1990 Building Owners and Managers Association International (BOMA) *Experience Exchange Report.* The statistics gathered in this report are for office buildings; however, discussions with commercial real estate managers reaffirmed our belief that this data would be applicable to the vast majority of RTC holdings. The methodology used for this calculation is described in more detail below.
- The true economic depreciation factor was derived from an article by Hulten and Wykoff titled "The Measurement of Economic Depreciation," which appeared in *Depreciation, Inflation, and the Taxation of Income from Capital* (edited by Charles R. Hulten and published by the Urban Institute Press in Washington, D.C.). In this article, the authors derive an economic depreciation factor of 3.61 percent of market value per year for industrial property and 2.47 percent for commercial property. The average of these numbers (3 percent) was used in the analysis.

CALCULATION OF HOLDING COSTS

A major factor enhancing the conclusion that an immediate sale is economically preferable to holding a property is the notion that there are significant costs associated with holding onto a property. The costs of holding property for the RTC are estimated at 9 percent of book value made up of 5 percent for maintenance and 4 percent for taxes and insurance.

These costs were estimated using data taken from the BOMA reports which reflected 1989 experience for buildings on a nation-wide basis. Since these estimates were for commercially viable property, adjustments were made to reflect the fact that some portion of RTC properties are vacant, or not occupied at commercially equivalent rates.

Where a commercially viable building would cost $5.40 per square foot per year to maintain, we estimate that the maintenance cost of RTC property is $3.30 per square foot.

In order to use these estimates in our calculations these cost estimates must be converted into a percent of market value. The first step in the process was to examine the net income generated by the property (also contained in the 1990 BOMA report). This calculation, based on 1989 values, is shown in Table 1.

Table 1.—PROPERTY INCOME CALCULATION

[Dollars per square foot]

Total Income	$16.50
less total oper + fixed exp.	8.03
less leasing expenses	1.56
Net operating Income	$6.93
less 10% vacancy	.69
"Net net" Income	$6.23

Industry practice is to subtract 10 percent of the net operating income to account for vacancy and rent collection loss. This leaves a "net net" operating income of $6.23 per square foot.

Based on industry experience, a capitalization ratio of 10:1 was used to calculate market value. Applying this ratio provides a capitalized market value of $62.37 per square foot. Dividing this market value estimate into the $3.30 per square foot operating expense estimate yields a 5 percent maintenance and upkeep cost figure.

TAXES AND INSURANCE

In addition to the maintenance costs, taxes and insurance must be factored into the costs of holding property. Although many of these properties are probably not currently generating tax revenue, loss of this tax revenue represents a true economic cost to governments at all levels. Thus, it is appropriate that it be considered in the analysis. Based on BOMA data, taxes and insurance average $2.56 per square foot. Dividing this by the $62.37 per square foot capitalized market value figure results in an estimate of 4 percent for taxes and insurance.

HOW MUCH RTC PROPERTY WOULD BE ELIGIBLE FOR AN RTC CREDIT?

The RTC held upwards of $13 billion of property as of April 30, 1990 and this total is growing daily as more S&Ls are acquired. Not all of this property would be eligible for the RTC Credit since some portion can be expected to sell at or near appraised value, and some portion would most likely not sell even with the tax credit. Based on the assumption that appraised values of RTC property are statistically normally distributed, we estimate that about 30% of all RTC property (or $4 billion using the April inventory) would be not be able to be sold at 90 percent or more of appraised value.

This estimate is likely to be low for several factors. First, since a large number of RTC properties are located in distressed markets, the distribution of appraised values may not likely be normal. Second, the weakness of these markets may have resulted in over appraisals.

ALTERNATIVE CASH FLOW ANALYSIS

We chose to analyze the cash flow impact of a $1 billion tax credit over a 6 year period. The RTC Credit would be authorized in two $500 million amounts each spread over 5 years. Thus the analysis was conducted over 6 rather than 5 years since the second authorization would be utilized in year six. An 80 percent tax credit would result in the sale of $1.25 billion of RTC property. Under the RTC Credit analysis depicted in Table 2, a positive first year flow is shown that is offset by negative flows in years one through six due to the impact of the 80-percent tax credit spread over the full period.

Table 2.—NET PRESENT VALUE OF CASH FLOW ANALYSIS

Year	Authorization ($ Million)			Comments
	1	2	Total	
1. RTC Credit Option				
0	$ 500		$500	Value of RTC properties sold
1	-100	$500	400	
2	-100	-100	-200	
3	-100	-100	-200	) tax credit spread
4	-100	-100	-200	) over five years
5	-100	-100	-200	
6		-100	-100	
NPV @ 9%		$415		

YEAR	CASH FLOW	COMMENTS
2. Hold Alternative ($ Million)		
0	$000	No revenues first year
1	-113	5% maintenance cost plus
2	-113	4% taxes and insurance
3	-113	
4	-113	
5	$961	Revenue from sale less 3% per year depr
NPV @ 9%	$239	

The net present value of the cash flows at a 9 percent discount rate, which reflects the RTC's cost of borrowed funds, is a positive $415 million, or 33 percent of the original $1.25 billion sales price. Although we might intuitively expect this to be only 20 percent (reflecting the 80-percent tax credit), the time value of money decreases the value of the future outflows, while leaving the immediate inflow at full value.

Under the "hold" alternative, no funds are received up front by the RTC. Rather, holding costs of 9 percent per year are incurred. A positive cash flow in the fifth year represents the sale of the property, but at a lower price reflecting economic depreciation of 3 percent per year net of the annual holding costs. The net present value of the "hold" alternative at the same discount rate of nine percent is a positive $239 million, 57% of the net present value of the RTC Credit option which incorporates the 80 percent tax credit.

STATEMENT OF DR. MARK LEE LEVINE

RTC AND TAX PROPOSALS:

A PRESCRIPTION FOR "ANOTHER" ECONOMIC DISASTER

I. INTRODUCTION: Most real estate practitioners are familiar with the huge asset holdings by the Resolution Trust Corporation ("RTC").[1] The creation of the RTC has seen tremendous expansion as a result of the failure of numerous savings & loan associations and the need to undertake the disposition and reorganization of various assets and liabilities involved in these institutions.

The focal point of this short note deals with the tremendous holdings[2] by RTC of real property interests and the apparent inability to efficiently and expeditiously dispose of those real estate assets.

Since the formation of RTC by the Financial Institution's Reform Recovery and Enforcement Act of 1989 (FIRREA of 1989), there has been a need to create an operational entity, RTC, to put into operation the terms of the FIRREA of 1989 law as to such assets. This has proven to be no small task.

With regard to the aspect of the disposition of RTC real estate, the focus of this note, it is apparent that things have moved far too slowly for many senators and representatives, along with their constituency.

Numerous anecdotical cases have been proffered to the press, RTC, congressional representatives and senators, and others who might listen to the problematic positions that many investors, real estate brokers, financial entrepreneurs, etc., have encountered as a result of their efforts to acquire RTC-type property.

Given that there are many administrative requirements and many steps to undertake the disposition of this property relative to complying with Federal law, there is also the concomitant concern that the longer property is held by RTC, the more costly it becomes for RTC, and, therefore, the tax-paying public.

Holding costs, whether in the form of property management issues, operational problems, administrative issues, changes in the marketplace, loss of income streams, or other considerations, it is apparent that these items are present and must be weighed.

Given that scenario, a purpose of this paper is to review and examine a few recent Proposals that have been made relative to RTC, to allegedly expedite the movement of property from RTC.

One of these Proposals deals with integrating tax changes for RTC-held property. These tax positions may include, but are not necessarily limited to, allowing special and favorable tax treatment for movement of property from the RTC to the hands of a private party.

In essence, a "plum" for a purchaser of RTC property is to vest that purchaser with additional tax blessings that would not be available to the "normal" purchase of a property from an entity other than the RTC. One question that must be examined is whether these tax benefits are the best approach, considering various facets of the Proposals.

This paper reviews some of the tax changes that are suggested in various Proposals relative to allowing more tax benefits to a purchaser of RTC property than would otherwise be present when a private party purchases property from an entity other than the RTC. This note examines the proposals on the tax issues that have been proffered as a means, arguably, to provide a solution to the enigma of disposing of the real estate held by RTC.

II. RTC, THRIFTS AND REALTY: The Resolution Trust Corporation was created and came into existence, as earlier mentioned, as a result of FIRREA of 1989. Its thrust was to resolve issues and take control of property involving insolvent thrift organizations.

As stated in an RTC publication,[3] its national real estate portfolio consists of numerous types of real estate assets. These include, but are certainly not limited to, office buildings, retail shopping centers, industrial warehouses, motels, land, single-family dwellings, condominiums, mobile homes, single-family lots, and numerous exotic-types or unusual types of properties, such as golf courses, resort properties, and other properties out of the main stream of normal real estate transactions for most real estate entrepreneurs.

This note does not examine the RTC. Reference to FIRREA of 1989 provides the technical provisions for the RTC. Numerous publications have been issued to examine and discuss many aspects of the RTC. Some of these are noted in the Footnote herein.[4]

III. DISPOSING OF RTC REALTY: THE PROBLEM: Inasmuch as the RTC has billions of dollars of real estate that must be disposed of as quickly and rapidly as possible, with given administrative requirements and given parameters that also inhibit the disposition of property, the concern is to find a solution or solutions that might aid the disposition of that real estate held by RTC.

It is abundantly clear that, as thrift institutions were not able to function and went bankrupt, RTC was formed to step in, acquire such institutions, and to manage the property in question.

Some property under RTC's jurisdiction has not moved as a result of various concerns and restrictions. These include "administrative nightmares." The large amount of properties that the RTC is to handle is overwhelming: Appraisal requirements, administrative requirements for approvals and the practical point that purchasers want a fire-sale position, if they are to acquire what is thought of as "distressed real estate."

RTC AND CAPITAL GAIN: Specific proposals date back over the last two (2) years, almost since the time of the formation of the RTC under the FIRREA Act in August, 1989. In particular, there have been proposals suggesting that one way to encourage the acquisition of such property might be through allowing various tax benefits in the form of special capital gain treatment for a purchaser of RTC property who subsequently disposes of that property, *i.e.*, to allow such person to pay less tax as a result of treating any gain as a capital gain.[5]

RTC AND PASSIVE LOSSES: Another tax proposal, along the same lines as noted, is to provide for elimination of passive loss rules with regard to the purchaser of property from RTC.[6] An elimination of the passive loss rules to a taxpayer would mean that a taxpayer who incurs a loss as a result of buying an RTC property and operating that property could take that loss and deduct that loss on the taxpayer's tax return, possibly thereby reducing the net taxable income to the taxpayer if the taxpayer has other income, such as that from an active trade or business or portfolio-type activities, such as income from dividends or interest. This would be a favorable tax benefit that is not available to most taxpayers in most settings under current law.

RTC AND TAX CREDITS: Another tax proposal that has been suggested deals with the use of a special tax credit that might be given to purchasers of property from RTC.[7] Various tax credits have been suggested in various formats. Whether the credit would allow for a given amount of tax reduction by the credit, over a given number of years, when property is acquired from the RTC and equity is placed in the property, is not as much the issue for this examination as compared to the broader question as to whether any tax credit should be allowed in this setting.

SPECIAL TAX TREATMENTS: The examination of this issue should be on the basis of whether tax benefits, whether they are in the form of special capital gain treatment, elimination of passive loss application rules, RTC-type credits, or otherwise, should be allowed when acquiring property from the RTC. As discussed in the next Section of this paper, it is this Writer's position that to allow such credits or other relief in this setting would be a disaster. It would generate new problems; it would not solve the existing problems.

IV. TAX PROPOSALS AND ECONOMIC DISASTER: Having closely followed many comments in the last year or so on the issue of tax relief for purchasers of RTC property, I believe that such legislation would produce an economic disaster, especially in what are often referred to as the "COLTA" states (Colorado, Oklahoma, Louisiana, Texas and Alaska). These states were, arguably, the most hard-hit, at least initially, with regard to economic depression as a result of overbuilding, related issues from the Tax Reform Act of 1986, the Savings & Loan collapse, deregulation issues and related points.

Obviously many other areas of the country are now suffering from the "COLTA"-type symptoms (depressed real estate values, foreclosures, business slowdowns, credit crunch, etc.). Be that as it may, it is clear in my mind that allowing special tax considerations would result in additional economic chaos.

A. To focus on only the elimination of the passive loss restrictions, as an example, realizing that a tax type of change, whether by passive losses, giving of capital gains, giving RTC credits, or otherwise, would produce, in my opinion, many of the same results as the following example, using passive losses to illustrate.

If a Potential Purchaser was in the process of reviewing two (2) buildings, A and B, with Building B owned by RTC and potentially subject to the exemption from the passive loss rules, certainly this would influence Potential Purchaser's decision.

All things being equal, that is, comparable buildings of A and B as to size, amenities, lease-up potential, etc., obviously the ability to buy Building B without the passive loss limitations would be extremely attractive.

This might seem the exact purpose of the Rule, but such advantage, artificially created by this legislation, in turn means a disadvantage to the owner of Building A.

The Seller of Building A would have that much more difficulty in disposing of Building A.

A prior Proposal for such legislation also coupled the advantage noted of eliminating passive loss limitations with the benefit of capital gain on disposition of the property for any buyer of such property, B in this Example.

Such legislation "increasing the value" of Building B would in turn diminish the value of Building A. This would be a factor to consider, no less than other factors that influence the price that is paid. Such price is influenced by favorable financing terms and other unique circumstances in a given transaction. Similarly, the price that might be paid would be influenced by the elimination of the passive loss rules.

In turn, if the reasoning is correct as to the differential in price that might be paid, this may encourage more defaults or non-RTC buildings, owned by owners such as that involving Building A.

Such activity or legislation might encourage additional defaults on properties similar to A, thereby allowing it, if the facts would permit, to come into RTC, thereby giving it the magic cloth of protection from the passive loss rules, etc.

Although I believe that some "relief legislation" can have merit, it should be balanced against the points noted.

It is reasonable to provide some legislation which might stimulate the marketplace. I am well aware of the opposing rhetoric that may exist as to this posture. I am sure the argument goes that such problem property was partially, if not fully, generated by improper activities, questionable building plans, lack of feasibility studies, dubious tax benefits that were obtained, and numerous other attributes that are questionable. The owners may have generated the problems in the market. The argument goes that to provide additional tax incentives to eliminate those results is not the purpose of the tax law, nor should the tax law step in under those circumstances, via Congress. Notwithstanding this rhetoric, there is merit to the position.

Historically, such as the circumstance with the previous glut of houses in the marketplace, tax incentives have existed to remove such glut of property. At one time there was a prior 5% potential credit that existed to eliminate the housing market glut. This is one (1) example of a reaction to a market problem that encouraged, for the benefit of the public, the movement of those houses.

It is no benefit to the public to cut one's nose off to spite oneself. That is, the longer we fail to reasonably react to eliminate RTC-type problems, the more costly the result will be to the taxpaying public.

The newspapers have a plethora of articles bemoaning the extreme costs of the RTC operations and the "bail-out" of the Savings & Loans.

Whatever the causes may be for the problems of the Savings & Loans, and certainly there is no dearth of commentaries on this issue, the bottom line is that the cost of holding property via RTC is continuing. It is escalating at almost geometric progression, at least given some of the estimates. What we can reasonably do to eliminate or reduce those costs is certainly something that should be weighed.

If such legislation were to be proposed to allow RTC to dispose of property that in turn would exempt the Purchaser from the passive loss rules, this may heal part of the wound with RTC, but it may open another major wound, potentially fatal, based on additional damage to the marketplace, as indicated by the earlier Example.

B. Whether it be an elimination of the passive loss rules, as illustrated, or the application of other tax benefits, as indicated, the application of those tax benefits to only RTC property would endanger what remains of many real estate markets.

V. CONCLUSION: It is extremely easy to attack someone's suggestions to eliminate problems in the RTC field. It is also incumbent to go further and suggest alternatives that might make some sense to expedite the movement of property from RTC, and, at the same time, not create additional problems.

ENTERPRISE ZONES: RTC!

If a similar proposal, as noted, would pass, except that in place of allowing the exemption from the passive loss rules for RTC-type property, the exemption might apply to property located in a "Distressed Real Property area", this may satisfy not only the purpose of the earlier-noted RTC Proposal, but also the major problem I have tried to identify, namely the damage to the remainder of the market because of the benefit to only RTC property.

What might constitute a "Distressed Real Property Area", as labeled, is something that could be determined by the appropriate authorities, as determined by Congress. (This may be the Treasury, RTC, or other overseeing body making the determination as to such Distressed Real Property Areas.)

We have, at this time, "disaster areas" and other areas that exist for relief in other settings within our body of law.

The advantage of a Distressed Real Property Area scenario allows taxpayers in various areas that are suffering, and that may develop problems, to have some relief to hopefully reasonably move properties in question. The idea is not to create a tax shelter, since we already are assuming a Distressed Real Property Area, property that is having difficulty in selling, and obviously property that would generate a loss, given the concern with the passive loss rules.

There are many arguments that can be made against designed tax relief for a given area or body. In this case the argument is that we, as taxpayers, via Congress, should not "bail-out" the builders and investors who find themselves in problematic situations because of the marketplace that they "created" as a result of questionable and negligent, at best in some cases, investment decisions. However, the issue is not whether a given person is aided, but whether such relief is beneficial to the society, in toto, given the damage that exists because of Distressed Real Property Areas, including RTC-type property considerations.

I am also aware of the purpose of Code §469 (Passive Loss Rules) and the argument that such purpose is frustrated by this Proposal. (Likewise, the change in capital gains and/or an RTC credit may suffer from the same point.) For the reasons stated, I do not feel that such purpose is frustrated.

What is absolutely clear in my mind is that legislation which would eliminate the passive loss rules or provide other tax relief on only RTC-type property would spell disaster to the remaining portions of the marketplace that are attempting to lease, sell and/or otherwise deal with problem properties that are not controlled by RTC. They are having a difficult time competing as it is. To simply provide a benefit for the RTC-type property would be a disaster to the remaining portions of the market.[8]

IN SUMMARY: Providing tax relief to purchasers of RTC property may provide an impetus for the disposition of that property. However, the use of an "RTC zone," as opposed to the specific RTC-type property, may eliminate the concern that has been raised in this article. Many share that same concern.[9]

FOOTNOTES

1. The Resolution Trust Corporation ("RTC") was created by the Financial Institution's Reform Recovery and Enforcement Act of 1989, herein sometimes referred to as FIRREA.

2. Although RTC has been noted in the newspapers as holding a huge amount of real estate, which is the case, real estate is only a small portion of the assets held by RTC. RTC must come to grip with other assets, such as numerous loan interests that are held in their portfolio. However, the focus of this note is on the real estate assets.

3. For example, see a discussion of the overview of RTC and its properties in the small and excellent booklet published by the National Association of Realtors entitled, "How To Do Business With the Resolution Trust Corporation," NAR (1990). This booklet addresses numerous issues as to dealing with the RTC, whether its large regional offices or consolidated offices.

4. See McCloud, John, "RTC, One Year Later: Going Nowhere Fast," Journal of Property Management 22 (January/February 1990). This article examines some of the concerns with RTC since its formation. Numerous articles exist that "bash" the RTC. The focus of this article is not to add to the litany of articles criticizing the RTC, but rather, it is to examine one suggestion that might aid the RTC, tax proposals to expedite the movement of property from the RTC.

For an examination of numerous RTC property issues, in many aspects of this RTC operation, see the RTC Property Disposition Report published by Data Trends Publications, Inc., 8130 Boone Blvd., Suite 210, Vienna, Virginia, U.S.A. 22182-2608.

5. As most readers know, 26 U.S.C.A. §1221, herein sometimes referred to as the "Code," provides for a capital gain rule. That Section provides for taxing capital gains, under current 1991 law, at a lower rate of 28%, as opposed to the regular rate which can exceed that 28% rate. Inasmuch as the highest stated rate under the Federal income tax law is 31%, the differential of 31% as opposed to 28% is not important enough to create incentive for taxpayers to push to obtain capital gain. Therefore, one of the arguments is to allow the capital gain treatment to provide more favorable treatment than the 3-point differential noted.

This approach might vary anywhere from going back to pre-1986 Tax Reform Act Rules, which prior Rule allowed the taxpayer to deduct 60% of any long-term capital gain and pay tax on only 40% of the gain, at the normal rates. Under this scenario, that would be a major differential and would certainly encourage activity by taxpayers as a result of this change.

For more on the issue of capital gains and treatment of these pre-1986 and post-1986 law changes, see Levine, Mark Lee, Real Estate Transactions, Tax Planning, West Publishing Co., St. Paul, Minnesota (1991 Edition).

6. The passive loss rules provided under Code §469 limit the ability of taxpayers to deduct net losses from rental real estate, generally speaking. Such limitation generally provides that such net losses cannot reduce income from other businesses that are deemed to be active in nature, such as businesses where a taxpayer generally earns his salary or commission. Likewise, taxpayers cannot reduce, under the passive loss limitation rules, income earned from what are determined to be portfolio-type sources, such as dividends and interest. A detailed discussion of this area is outside the scope of this Work. For more in this area, see the Levine text, cited supra, Footnote 5 herein. See also the direct reference to Code §469 and the Regulations thereunder.

7. Both the capital gain position and the passive loss position were suggested in various proposals over the last few years. In particular, there was a Proposal by then Representative Brown, now Senator Brown, from the State of Colorado. That Proposal allowed for consideration of capital gain issues and passive loss issues. The detailed discussion of the tax credit has come about in various Proposals. One such Proposal is a bill in the Senate that suggested a tax credit that might be labeled the "Real Estate Revitalization Credit Act of 1991." That label was under Senator Roth's Proposal.

8. The old saying, "Fool me once - shame on you; fool me twice, shame on me," can apply in this setting. We made many mistakes in the tax area, including, argue many commentators, many changes under the Tax Reform Act of 1986. Arguably, many of these changes precipitated or exacerbated the current problems in the real estate market. We should not add to these problems by creating a scenario by favoring RTC property and, therefore, force other property into economic straits, as illustrated in the examples in this Note.

9. Although House Minority Leader Robert Michel, Republican from Illinois, in April, 1991, suggested special tax breaks to encourage taxpayers to buy RTC properties, he, and many others, would do well to heed the concerns noted herein and expressed by other organizations that have clearly examined this issue.

The National Association of Realtors, through their Realtors Legislative Council, has expressed concern with this RTC position in its limited format of applying the rules to only a specific property. See the same point expressed by the National Realty Committee in statements issued through that Committee in April, 1991. The same point has been made through the National Council of Saving Institutions in a statement issued in April, 1991.

STATEMENT OF THE U.S. LEAGUE OF SAVINGS INSTITUTIONS

The U.S. League of Savings Institutions* welcomes this opportunity provided by the Taxation Subcommittee to comment on the newly introducted legislation by Senator John Breaux (D-LA), S. 1787, entitled "Asset Disposition and Revitalization Credit Act of 1991." The savings and loan business applauds the concern and good intentions behind this legislative effort. Unfortuately, as currently structured, it falls short of solving the true cause of the underlying problem -- the continuing national real estate depression.

Overview

As major real estate lenders, our member institutions have been on the front lines of this fight. The depressed real estate market has exacted a heavy toll on this nation's savings institutions. Its devastating effects are continuing to spread and now infect our commercial banking and insurance industries. We can no longer ignore the ongoing real estate crisis. The consequences of inaction on this important issue have already been enormously costly and are certain to negatively impact future generations. New economic initiatives and tax changes must be considered in a national effort to restore value to our depressed real estate markets.

Summary of S. 1787

The legislative approach outlined in S. 1787 would provide purchases of real property held by the Resolution Trust Corporation (RTC) a tax credit to be claimed over five years. The credit could be as large as 80 percent of the purchase price of the property. The actual percentage would be set by the RTC in an amount sufficient to sell the property. The taxpayer's basis in the purchased property would not be reduced by the allowable credit. The aggregate amount of credits for this new pilot program would be limited to $1 billion.

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* The U.S. League of Savings Institutions serves the more than 1900 member institutions savings association and savings bank businesses. League membership includes all types of institutions -- federal and state-chartered, stock and mutual. The principal offices include: Donald B. Shackelford, Chairman, Columbus, Ohio; Frederick L. Webber, President, Washington, D.C.; and J. Denis O'Toole, Executive Vice President for Government Affairs. League headquarters are at 1709 New York Avenue, N.W., Suite 801, Washington, D.C. 20006. Telephone: (202) 637-8900. The Chicago office is located at 111 East Wacker Drive, Chicago, Illinois 60601. Telephone: (312) 644-3100.

Competitive Inequities

The U.S. League believes that this well-intentioned tax credit proposal limited exclusively to RTC property will compound the damage to competing real estate owned (REO) by depository institutions, among others, by driving down its market value. In other words, a tax credit will tier the marketplace in favor of RTC properties and disadvantage all private sector REO sales. By paralyzing competing REO sales, the new credit would create additional real estate loss pressures on financial institutions still struggling for survival. Any increase in the failure rate of these marginally solvent institutions, ironically, will only add to the growing inventory and cost of the RTC.

RTC Advantages Raise Fairness Concerns

The application of the 'at risk' rules to real estate in the 1986 Tax Reform Act penalized REO seller-financing for private financial institutions. However, because it is a government entity, the RTC can provide seller financing without adverse impact on depreciable basis for the buyer. As a result, financial institutions are having great difficulty disposing of their increasing REO volume. This proposed RTC credit will make their task even tougher. Identical real estate properties will have dramatically different market values depending on whether they are owned by the government (RTC) or private financial institutions. This raises the fairness issue in view of the fact that the federal government is utilizing taxpayer dollars to provide a credit to boost RTC property sales in direct competition with taxpaying financial institutions. Financial institutions would probably much rather take their chances with the marketplace solution of supply and demand. While the "hands-off" approach may not move RTC properties as quickly as a tax credit, our member institutions certainly feel it is fairer and more equitable and, in the longrun, probably less costly.

Least Cost Approach?

The structure of this proposed RTC tax credit could be very expensive to the federal government and thus, the American taxpayers. In certain cases, the RTC is authorized to grant a credit of up to 80 percent of the property's purchase price. The buyer is not even required to reduce the property's basis by an amount equivalent to the credit. Therefore, depreciation can be taken on the entire purchase price of the property at the same time the credit is reducing the buyer's overall tax liability. It is likely that the benefits from this tax credit could exceed on occasion the value of the underlying RTC property and attract buyers primarily for the tax benefits rather than the economic value of the sale. Such an overly generous tax provision is a vivid reminder of the dramatic distortion that can be caused by the tax code when used to create real estate markets (i.e., pre-1986 tax laws) rather than supplement them.

Credit Won't Lift Real Estate Markets

The cost of maintaining and carrying nonproductive property is an expense borne by all real estate lenders, not just the RTC. Therefore, creation of a tax credit to speed the sale of only RTC properties will not help stimulate a rebound in the real estate markets, particularly in the short-term as the competitive advantage of the credit will be readily apparent. No one believes that this tax credit will either totally remove RTC properties from the marketplace or do it in such a timely manner as to avoid wholesale private sector losses. Real estate lenders are concerned, however, that the more successful the RTC tax credit, the larger their own REO problem and the greater the risk of additional conservatorship and receivorship cases.

Conclusion

For all the foregoing reasons, the targeted tax credit in S. 1787 is not the answer to the nation's real estate depression. Nor is it the answer to increased taxpayer liability from burgeoning RTC disposition costs. Nevertheless, the U.S. League believes that some changes can be helpful and offers the following recommendations to the subcommittee in the hope of reviving the depressed market value of real estate and the closely related financial strength of our member institutions.

1) Exempt real estate owned from the 'at risk' limitations of Sec. 465(b)(6).

2) Modify the passive loss rules to allow professional real estate participants to deduct their legitimate expenses of owning and operating rental real estate (S. 1257).

Thank you for the opportunity to comment on this very important membership issue for savings institutions.

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