Council for **A**ffordable and **R**ural **H**ousing

Serving the Affordable Housing Needs of Rural America

April 15, 2015

Senate Finance Committee
U.S. Senate
219 Senate Dirksen Office Building
Washington DC 20510

Attn: Chair and Ranking Member, Senate Finance Committee
Hon. Orrin Hatch
Hon. Ron Wyden

Attn: Community Development and Infrastructure Working Group
Hon. Dean Heller
Hon. Michael Bennet

RE: Senate Finance Committee Tax Reform Working Group

Dear Senators:

The Council for Affordable and Rural Housing ("CARH") appreciates the opportunity to provide our views on the work of the Senate Finance Committee as it reviews our nation's tax code and identify opportunities for meaningful reform. CARH writes to emphasize the importance of the Low Income Housing Credit (Housing Credit) and multifamily tax exempt private activity housing bonds (Housing Bonds) programs. We also identify reform opportunities—that would increase the effectiveness of the programs by allowing for greater leverage of private funds and to better align taxpayers' incentives with the government's interest in providing decent and affordable housing to rural areas.

CARH represents more than 300 non-profit and for-profit housing providers and local trade associations in America's rural communities. For 35 years, CARH has served as the nation's premier association for participants in the affordable rural housing profession, including builders, owners, developers, managers, non-profits, housing authorities, syndicators, accountants, architects, attorneys, bankers, and companies that supply goods and services to this vital industry and housing elderly and disabled residents and working families throughout rural America.

I. Support Continuing and Strengthening the Housing Credit and Housing Bond Programs

Since its inception, the Housing Credit program has created homes for approximately 2.4 million families. For each 100 apartment units, 116 jobs are created, generating more than $3.3 million in federal, state and local revenue. This important housing program creates broad-based economic benefits, including :(1) jobs (particularly construction jobs), (2) income, (3) increased federal, state, and local taxes; and (4) increased economic activities in industries such as manufacturing, trade, and services . Affordable housing not only creates jobs directly, but facilitates job growth, especially in rural areas. Affordable housing shortages prevent workers from meeting job demand in rural areas with limited housing options.

Rural housing construction and preservation projects have few funding sources. The Housing Credit program is a vital source for this important housing. The Housing Credit is narrowly targeted and represents the best of the public-private partnership between government, local communities and the private sector. The program is the most successful affordable rental housing production program and its place in the tax credit code is an essential part of its long-term success. Indeed, Housing Credit has been so successful that it has become the model for subsequent programs.

In addition, to protecting and preserving the Housing Credit and Bond programs as permanent sections of the tax code, CARH supports efforts in both the House and Senate which would make permanent and expand the temporary minimum credit rate for the 9 percent Housing Credit program, as well as provide for a minimum 4 percent Housing Credit rate for the acquisition of affordable housing. The Tax Increase Prevention Act of 2014 that passed at the end of the last Congress provided a fixed floor rate through the end of 2014 for the 9 percent credit. Unfortunately, as a result of the timing of when the legislation was enacted, there were very few owners or developers who could use this flat rate because allocations of tax credits had already been made using a variable rate. For a majority, it would not be feasible for transactions to be resubmitted with the fixed rate. A fixed rate for both the 9 percent and 4 percent Housing Credits would provide substantial benefits, in particular long-term certainty, which is currently lacking.

The Housing and Economic Recovery Act of 2008 (HERA) set the rate for new construction and substantial rehab Housing Credits (also known as 9 percent credits) from each state's allocation at no less than 9 percent, the amount originally envisioned when the program was created in the Tax Reform Act of 1986 ("86 Act"). This removed the uncertainty and financial complexity of the floating rate system, simplified state administration, and facilitated development of affordable housing after HERA's enactment. This provision expired for apartments placed in service after 2013, with a temporary extension at the end of last year for 2014 allocations. Without this permanent change, developments will need to be underwritten at the floating rate, creating a substantial reduction in the amount of equity that a development could receive for its allocation (though with no change in the amount of credits allocated).

In the federal fiscal environment where gap financing from HOME, CDBG, and other local sources are at risk, such a cut in equity would make the development of affordable housing even more difficult. Making the fixed floor rate permanent would not increase the number of Housing Credits allocated, as they are capped annually. It just affects how much allocation each project may receive.

In addition to the new construction and substantial rehab credits, states are allowed to provide Housing Credits from their capped allocation for the acquisition of existing property, an important tool for affordable housing preservation. Acquisition credits are currently set by the floating rate system just like new construction and substantial rehab credits were pre-HERA. Applying the fixed floor rate for acquisition credits at no less than 4 percent would similarly remove the uncertainty and financial complexity of the floating rate system, simplify state administration, and facilitate preservation of affordable housing at little or no cost to the federal government. Acquisition credits are less than 10 percent of all allocated credits, so the incremental additional cost of extending the fixed floor rule to acquisition credits would be minimal.

II. Reform of Passive Activity Loss Limitations

CARH also believes that tax reform can improve an already successful program. The Housing Credit program is based on corporate investment, with strictly limited personal or non-corporate investment. If well-capitalized community banks, many of which are organized as limited liability companies or S

corporations, and are located in rural areas, could invest in the Housing Credit program, more credits would be more available for rural transactions and pricing would be higher.

A number of these organizations have approached CARH over the years about investing in the Housing Credit program, but the Internal Revenue Code's restrictions on use of losses from passive activities present an issue to such investment. The Code currently includes a rule limiting the extent to which individual investors may include net losses from passive investments, including real estate. This limits the ability of associations that are not real estate professionals from investing in housing credit projects and artificially limits the competition for tax credit investment opportunities. The limitations apply to the housing credit program, with an exception allowing investors to take credits each year up to an equivalent of $25,000 in deductions. This also affects certain pass-through entities—including certain partnerships, LLCs and S corporations—and closely-held C corporations.

Local community banks should be allowed to invest in their communities through housing credits to the same degree credits are currently available to widely held C Corporations. To ensure high standards of oversight, such entities should have at least $10 million in annual gross receipts, be formed for reasons other than just avoidance of Federal income tax, and have an expectation of reasonable asset management. This proposal is aimed at accessing substantial investment capital available from sophisticated financial institutions and businesses that happen not to be C Corporations. Indeed, this change would allow the 1,954 commercial banks and 55 savings institutions to invest in low-income housing tax credits in the communities in which they operate.

III. Targeted Exit Tax Relief To Aid Preservation And Mitigate an Unintended Harm

Tax reform should also provide limited relief from exit tax burdens that discourage cost-effective preservation of existing affordable housing. Similar legislation has been introduced in previous Congresses.

The Section 515 rural housing program, funded by private capital and government funds under Section 515 of the Housing Act of 1949, was for many years the most important affordable housing production program for rural America. This housing was built using very low interest rate government loans and private capital raised through the provision of tax benefits. Ominously, the current stock of Section 515 housing is at considerable risk due to the interplay between the design of the program and the tax depreciation recapture rules.

Real estate of all types is periodically updated and rehabilitated as an essential part of property operation and maintenance. Without periodic injections of new investment capital to fund these renovations, projects deteriorate, even to the point that they are unsafe or unsanitary. Maintenance of the existing housing stock is generally more cost effective than fixing or replacing a building that has been allowed to deteriorate.

However, almost all Section 515 properties were constructed through limited partnership arrangements whose structure makes it exceedingly difficult to introduce new capital into these properties, either through additional capital contributions from current owners or through the transfer of such properties to new owners. Because of rent restrictions that limit any cash flow from the property, new capital contributions would only generate additional passive losses which cannot be utilized by current

investors. Yet, if the current owners sell the property it is almost impossible to generate sufficient cash to pay off the steep recapture taxes that would be owed. The best alternative for current limited partners is to hold the investment until death, enabling their heirs to acquire the property with a stepped up basis that avoids any recapture taxes.

Most Section 515 properties were also developed before the 1986 Act. As a result, owners were locked in to the program without receiving most anticipated benefits. A modest change in the tax rules would allow owners to at least exit out of the program and permit preservation of this affordable housing at minimal revenue cost to the federal government. Most of these owners are individuals who invested decades ago in small apartment complexes (average size 24 units) and are now elderly and often seeking to retire.

The depreciation recapture tax liability should be waived if investors sell their property to new owners who agree to invest new capital in the property and to preserve the property as affordable housing for another 30 years. Since in practice very few investors facing this choice pay recapture taxes—opting instead to pass on the property to their heirs at a stepped-up basis—this proposal would result in little foregone tax and the true cost would be modest. The benefit to the federal government would be far reaching: allowing for economically motivated rather than tax-driven uses of these existing resources, and preserving existing affordable housing and extending its affordability in a cost-efficient manner. By incentivizing rehabilitation projects, this proposal would also lead to employment in rural areas across the country. In addition to the public benefit, this additional economic activity may result in other tax revenues to the federal government as well as state and local governments. And, this waiver could be limited to where cash is not available to the seller's net expenses. This way, where there is net cash to the seller, it is unlocked and the federal government would recover tax payments.

CARH appreciates the opportunity to comment on the work of the Senate Finance Committee and looks forward to additional opportunities to provide feedback to support the ongoing tax reform effort. If you have any questions about the foregoing, please contact me at (703) 837-9001 or cfisher@carh.org.

Sincerely,



Colleen M. Fisher
Executive Director