STATEMENT BY
THOMAS F. MORAN
CHAIRMAN AND MANAGING PARTNER
MORAN & COMPANY
ON BEHALF OF THE
NATIONAL MULTI HOUSING COUNCIL
AND THE
NATIONAL APARTMENT ASSOCIATION
BEFORE THE
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FOR THE HEARING ON
"TAX REFORM AND RESIDENTIAL REAL ESTATE"

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Chairman Camp and Ranking Member Levin, the National Multi Housing Council (NMHC) and the National Apartment Association (NAA) would like to thank you for this opportunity to testify on the multifamily industry's priorities for tax reform. We applaud your efforts to examine the nation's tax code with an eye toward enacting tax reform that simplifies the nation's tax laws while promoting economic growth and job creation.

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

Background on the Multifamily Housing Sector

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

In communities across the country, apartments work – helping people live in a home that is right for them. Whether it is young professionals starting out, empty nesters looking to downsize and simplify, workers wanting to live near their jobs, married couples without children or families building a better life, apartment homes provide a sensible choice to meet their specific housing needs.

Apartment homes and our 35 million residents contribute $1.1 trillion annually to the economy. That is nearly 26 million jobs in construction, operations, leasing, management and skilled trades, as well as all the local businesses supported by apartments and the millions who live there. This tremendous economic impact is comprised of the following:

- New apartment construction produced $14.8 billion in spending, supported 323,781 jobs, and had a total economic contribution of $42.5 billion.

- The operation of the nation’s existing apartments accounted for $67.9 billion in outlays, 2.3 million jobs, and a total economic contribution of $182.6 billion.

- Apartment resident spending totaled $421.5 billion, supporting 22.8 million jobs and a total economic contribution of $885.2 billion.

Demand for apartments continues to grow. With 77 million Baby Boomers who may consider downsizing and nearly 80 million Echo Boomers beginning to enter the housing market, it is no surprise that Harvard University research suggests that up to seven million new renter households will form this decade.

Unfortunately, supply is already falling short of meeting this demand. An estimated 300,000 to 400,000 units a year must be built to meet expected demand; yet just 158,000 apartments were delivered in 2012 – not enough to even replace the units lost every year to demolition and obsolescence. Furthermore, while the market continues to work through an oversupply of single-family housing, the nation could actually see a shortage of multifamily housing. The shortage is particularly acute for low- and moderate-income households. The Harvard Joint Center for Housing Studies estimates a nationwide affordable housing shortfall of three million units.

Key Priorities for Tax Reform

Like many other small businesses, the apartment industry has a considerable stake in tax reform. In addition, we provide homes for millions of Americans covering the entire socioeconomic spectrum. We pay taxes when properties are built, operated, sold, or transferred to heirs. As the Committee drafts legislation, we ask that tax reform takes special care not to harm the thousands of businesses in the industry or the 35 million residents who call an apartment home.

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

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

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

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

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

A "carried interest," also called a "promote," has been a fundamental part of real estate partnerships for decades. Carried interest was designed to offset the considerable financial risks our firms take – including recourse debt on construction and rehabilitation loans, litigation, refinancing risk, cost overruns, and environmental remediation. In fact, one in ten multifamily projects never break ground. These risks have major financial consequences that carried interest helps offset, justifying capital gains treatment.

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

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

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

Additionally, it should be noted that proposals that have been made to tax carried interest at ordinary income rates as opposed to capital gains tax rates would retroactively recharacterize income from capital gain to ordinary. It is extremely unfair to change not just the tax rate, but also the characterization of income in such a retroactive manner, which, in many cases, could be well over a decade after the underlying partnership was formed. Moreover, modifying the tax treatment of carried interest would force the general partner to face ordinary income tax rates while the limited investment partners would see capital gains rates. There is little justification for such a disparity that would certainly disrupt the decision making of real estate partnerships that never anticipated that the character of income would be changed. Thus, if Congress were interested in modifying the tax treatment of carried interest, it should do so only with respect to real estate that comes into existence after the effective date of the proposal.

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

Priority 3: Retain the Full Deductibility of Business Interest

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

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

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

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

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

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

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

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

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

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

Priority 5: Preserve Current Law Estate Tax

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

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

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

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

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

Priority 6: Provide Incentives for Improving Energy Efficiency in Commercial Buildings and Large Multifamily Properties

As the Committee considers how the tax code could be used to facilitate national priorities in the energy sector, we wish to call your attention to the Energy Efficient Commercial Buildings Tax Deduction (Sec. 179D of the Internal Revenue Code of 1986) and the importance of this incentive in achieving improved environmental quality, reinforcing our national security, creating jobs in the construction and manufacturing sector and increasing housing affordability by decreasing utility expenses for millions of Americans who live in apartment homes.

S. 3591, the *Commercial Building Modernization Act*, which was introduced in the 112th Congress, provides a responsible plan for enhancing the current Sec. 179D to assist property owners to make meaningful improvements in the energy performance of their properties. Many older properties have been unable to fully utilize the current-law incentive because they have had difficulty in achieving the requisite 50 percent improvement in building energy performance over the level specified in the 2001 version of the American Society of Heating, Refrigerating and Air-Conditioning Engineers (ASHRAE) 90.1 code. While S. 3591 includes updated energy code references against which whole building performance will be measured for many properties, it also includes a pathway for older properties to qualify for incentives that will assist property owners in making building system upgrades that will yield significant energy savings.

Older building structures face technical limitations in achieving the energy performance metrics specified by the current code, let alone reaching the incremental “above-code” performance characteristics required to claim the current deduction under Sec. 179D. S. 3591 establishes a sliding scale of energy improvements, using the property’s current energy performance as the baseline. This pathway of significant improvement in energy performance relative to the property’s own baseline performance will provide a much-needed financial tool for property owners who want to make these types of investments but have not been able to do so.

Advances in residential construction methods have improved the energy use profile of new buildings; however the majority of the nation’s building stock predates the use of highly energy efficient products and techniques. The U.S. Department of Energy (DOE) reports that housing built after 2000 used 14 percent less energy per square foot than housing built in the 1980s and 40 percent less than housing built before 1950.[1] As such, there is considerable room for improvement in energy performance even among well designed, constructed and maintained properties. A recent study conducted by CNT Energy and the American Council for an Energy-Efficient Economy finds that “[b]uilding owners often need financial incentives to adopt new technologies or equipment with higher up-front costs. Despite this, studies have documented

[1] U.S. Department of Energy, 2011 Buildings Energy Data Book. March 2012. Chapter 2.

that affordable housing, often multifamily, receives a disproportionately small share of available energy efficiency funding."[2]

According to the American Housing Survey (2009), almost 81 percent of the nation's stock of apartment properties (with 5 or more units) was constructed prior to 1990, which marks the decade in which the first building energy codes were implemented. This older stock of housing, which is an important source of affordable housing, represents a significant opportunity for achieving energy savings while at the same time adding to the available spending capacity of individuals who live in these apartment homes. This is a significant consideration given that in 2010 approximately 70 percent of renter households had incomes below the *national median* and more than 40 percent had incomes in the bottom quartile.[3] Furthermore, "energy costs as a share of gross rents rose from 10.8 percent to 15.0 percent between 2001 and 2009. Lowest income renters saw the largest increase in their utility share, a jump from 12.7 percent to 17.4 percent."

There is a direct relationship between the age of a residential building and energy expenditures. The per-square-foot energy costs of housing constructed between 1980 and 1989 is 16 percent higher than that of a building constructed after 2000. Those expenditures soar to a 28 percent increase in residential buildings built between 1970 and 1979 over post-2000 properties.[4] Energy efficiency in multifamily properties could be economically improved by 30 percent with a savings of $9 billion in averted energy costs not to mention the substantial savings in greenhouse gas emissions.[5]

NMHC/NAA believe that a sound national tax policy can be used to catalyze a market transformation marked by significant improvements in building energy performance. A meaningful and predictable tax incentive would leverage private investment in qualified building retrofits and would have a positive effect on the economy as it would result in increased demand for construction services, materials and equipment.

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[2] CNT Energy and American Council for an Energy-Efficient Economy, Engaging as Partners in Energy Efficiency: Multifamily Housing and Utilities. January 2012. http://www.cntenergy.org/media/Engaging-as-Partners-in-Energy-Efficiency-MF-Housing-and-Utilities-Final-012512.pdf. p.4.

[3] Joint Center for Housing Studies of Harvard University. America's Rental Housing-Meeting Challenges, Building on Opportunities. 2011. p. 17 http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/americasrentalhousing-2011.pdf; U.S. median household income fell from $51,144 in 2010 to $50,502 in 2011 according to the *United States Census, American Community Survey Briefs*, September 2012, Appendix Table 1, page 5.

[4] U.S. Department of Energy, *supra* note 1, at p. 2-20 derived from Table 2.3.12.

[5] Joint Center for Housing Studies of Harvard University, *supra* note 2, at p.33.

Conclusion

In closing, NMHC/NAA look forward to working with the House Ways and Means Committee, as well as the entire Congress, to craft tax reform legislation that would promote economic growth and the nation's multifamily housing needs. On behalf of the apartment industry and our 35 million residents, we stand ready to work with Congress to ensure that the nation's tax code helps bring apartments, and the jobs and dollars they generate, to communities nationwide.