TRANSFORMING THE TAX CODE: AN EXAMINATION OF THE PRESIDENT'S PANEL ON TAX REFORM RECOMMENDATIONS

House Committee on Small Business

Joint Subcommittees on Tax, Finance & Exports and Rural Enterprises,

Agriculture and Technology

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Mr. Chairman: My name is Andy Loftis. I am an owner of a Keller-Williams Realty of Greater Athens in Athens, Georgia. Currently our company employs about 40 sales agents. We are engaged in both residential and commercial real estate sales and development. I am speaking here today as a constituent of Mr. Barrows and also as a member of the NATIONAL ASSOCIATION OF REALTORS®. (NAR) My oral and written statements are presented on behalf of NAR and its 1.2 million members.

The President's Advisory Panel on Tax Reform has made a series of recommendations that would, if enacted, be disastrous for the real estate industry and for the entire economy. The Nation's current 69% homeownership rate is the highest in our history. We are puzzled that lawmakers would even *consider,* much less implement, changes that would undermine that remarkable achievement. Are there challenges facing the real estate industry? Indeed, there are. Would those challenges go away if Congress were to reduce or eliminate longstanding, familiar and straightforward tax rules associated with real estate ownership? On the contrary, reducing or eliminating the tax rules that apply to existing property would cause cataclysmic disruption.

Tax Reform Recommendations that Affect Real Estate: The Panel proposes the following:

- Convert the mortgage interest deduction to a tax credit
- Limit the deduction to interest expense on a principal residence (i.e., no deductions for interest on second homes)
- Reduce the current law cap on allowable indebtedness (currently $1 million of debt, secured by as many as two residences) by as much as $800,000 by conforming the cap to FHA loan limits
- Repeal the mortgage interest deduction for home equity loans
- Repeal the deduction for state and local property taxes
- Allow purchasers of investment real estate to deduct the cost of acquiring the property and eliminate any interest expense deductions associated with the purchase – OR –
- Require real estate investors to recover the cost of investment real estate over approximately 33 years (residential property) or 45 years (non-residential property).

As a practical matter, the NATIONAL ASSOCIATION OF REALTORS® opposes each of these changes. While our comments will mostly describe the negative impact of reducing the mortgage interest deduction, note that similar arguments would apply to most of these proposed real estate taxation changes. We choose to emphasize the mortgage interest deduction because it is among the most familiar provisions in the entire Internal Revenue Code.

As we talk about the mortgage interest deduction, do understand that the negative fallout of changing longstanding tax rules would extend beyond homeownership. A little known fact is that, according to Federal Reserve data, American families *in every income category* own investment real estate. These investments can range from the smallest cottage or condo to an interest in a magnificent skyscraper. Notably, the IRS has not identified any pervasive or abusive tax avoidance within either the residential or investment real estate sector. Since the early 1990s, real estate investment deals have generally been based on their economic merit and not generated as part of an elaborate tax shelter scheme. The current law caps on mortgage interest deduction have been in place since 1987 and have not been indexed for inflation. We are therefore shocked that the Panel would recommend punitive new tax rules in light of the satisfactory rates of tax compliance in all sectors of the real estate industry over recent years.

Real estate investments, both in both homes and commercial property, build savings and individual wealth, provide tax revenues for local governments, and stimulate growth in all real estate-related industries. Indeed, we believe that *America was built on real estate*. Over the past several decades, about fifteen to eighteen percent of Gross Domestic Product is associated with real estate ownership and services.

Because they are so widely dispersed throughout our economy, real estate investments and homeownership are hardly a *special* interest: they are the *common* interest. We would therefore ask the Committee to focus on three main aspects of real estate ownership and investment today. These remarks will describe the role of real estate in the small business sector, make observations about how the tax reform goals of “fairness and simplicity” are reflected today in the real estate sector and assess the importance of real estate as a mechanism for savings for so many Americans.

The Role of Real Estate in the Small Business Sector: No matter how large or small the size and operations of a firm, most business activities take place in offices, retail space, warehouses, industrial parks and similar developed real estate settings. Thus, business owners have every interest in assuring that their place of business is maintained and operated in a manner that supports their goals and objectives and that projects the image that the business owner wishes to convey to the public.

All small business owners, no matter what their line of business, have a stake in maintaining a vibrant real estate economy. A vibrant real estate economy assures that business properties are maintained properly, that rent levels are both fair and competitive and that necessary improvements and upgrades are made on a timely basis. Moreover, in

each community, a vibrant real estate market assures that locations and facilities remain attractive, well-maintained and desirable places to do business. In addition, many small businesses support real estate operations, including local printers, local newspapers, paint stores, home furnishing stores and similar endeavors.

Real estate businesses themselves are generally small businesses. NAR's survey of Realtor firms indicates that, notwithstanding increased consolidation, about half of all real estate brokerage firms are independent, non-franchised companies. More than 90% of all residential real estate brokerage firms have only one office. Among that group, more than 90% have fewer than 10 sales associates. Thus, real estate brokerage remains a decentralized, local business. As firms, therefore, Realtor interests would be the same as any other small businesses – and those interests include having top notch office space with good locations.

A Simple and Fair Tax System: Tax Reform Goals and Real Estate: The Internal Revenue Code is remarkably complex – but not when it comes to homeownership. A homeowner with a mortgage receives a form (IRS 1098) from the lender that specifies, to the penny, the amount of interest (and usually the amount of taxes) paid. The individual transfers the number(s) to the appropriate line(s) on the tax return. That's it. No complexity, no schedules, no worksheets, no special knowledge and no appraisals required. Real estate ownership does not contribute to the tax system's complexity.

If one were designing a tax system from scratch, that system would almost certainly look very different from what we have today. Taken as a whole, the current system is overloaded with complexity and with inconsistent and sometimes odd provisions. Nonetheless, sweeping tax-law changes create both winners (who end up paying less tax) and losers (who end up paying more). If the Reform Panel's real estate recommendations were to be adopted, residential, commercial and investment real estate would all be big losers. Because the current tax rules affecting real estate are not complex, we see no apparent justification for revising them.

The goal of "fairness" in a tax reform debate is to assure that similarly-situated taxpayers are treated "the same." Some critics point out that only about one-third of taxpayers itemize their deductions. Accordingly, they reason, the rules are not "fair," as not all homeowners (and few renters) receive the tax benefits associated with itemizing deductions. While only about one-third of taxpayers itemize deductions in any particular year, the critics' arguments about "fairness" ignore the reality that, *over time*, far more than one-third of taxpayers receive the benefits of itemizing. Mortgages get paid off, other new homeowners enter the market and family tax circumstances change.

Arguably, the standard deduction gives non-itemizing taxpayers a "better" answer than utilizing the mortgage interest deduction, so it is not clear that non-itemizers have been put at a

disadvantage. As a general rule, individuals itemize their deductions when the total of allowable deductions exceeds the standard deduction. Taxpayers who utilize the standard

deduction thus receive a greater reduction of their taxes than they would if they itemized because the total of their allowable deductions is *less* than the standard deduction. Notably, every year the IRS reports that some taxpayers who would be eligible to itemize choose rather to use the standard deduction. This underscores the utility of the standard deduction as an important simplification component of the tax system.

IRS Statistics of Income data show that the taxpayers across all income categories use the mortgage interest deduction (MID). In 2002, more than one million of the 36 million itemized tax returns with a mortgage interest deduction reported an adjusted gross income of less than $20,000. A little more than 60 percent of the families who claim the mortgage interest deduction have household incomes between $60,000 and $200,000. While it is true that in any particular year only about one-third of taxpayers itemize, it is notable that of the taxpayers who *do* itemize deductions, more than 60% utilize the MID. Their deductions account for about 80% of all mortgage interest paid.

Savings and Wealth: Homeownership and the Tax System: Critics claim that the mortgage interest deduction (MID) operates as an inducement for people to buy homes. Realtors can confirm that people don't buy homes *because* of the MID. They buy homes to satisfy many social, family and personal goals. The MID *does*, however, *facilitate* homeownership because it reduces the carrying costs of ownership. Homeownership is the cornerstone of a healthy community, the basis for positive community involvement and a family's first step on the ladder to wealth.

Despite dramatic growth in homeownership over the past 5 years, a gap persists between the homeownership rates of Caucasian Americans as compared with African Americans, Hispanics and other minority groups. We believe that any elimination or reduction of the mortgage interest deduction would exacerbate this ownership gap. In recent years, minority groups have comprised the largest share of first-time homebuyers. This is a trend that should continue. Changes to the MID could erode our progress.

Some economists believe that if less money were invested in real estate and owner-occupied housing, more money would be invested in "productive" assets such as stocks and equipment. In fact, the Panel has articulated this perspective. *We are aware of no evidence showing that owning these financial assets can provide the foundation for community life, lead to the development of quality public schools, foster lower crime rates or contribute to the tax base of the local government.*

The purchase of a home symbolizes an investment in the future and a commitment to a community in ways that no other asset can. Note, too, that so-called "productive" business and investment activities associated with stocks and equipment take place in some sort of developed real estate space. Clearly real estate is fundamental to a "productive" economy.

Moreover, it is not a foregone conclusion that individuals who purchase residences for their families would necessarily have the requisite skills to choose and purchase stocks or other securities. Similarly, no family is likely to acquire manufacturing equipment as a

means to improve their community or schools. At least one Panelist stated that if families bought smaller houses they might buy more stock. *We do not believe it is the function of the tax system to determine the size of a house for any family or its method of saving.*

We do know that some portion of a real estate asset's value is based on its favorable tax treatment. No one knows just how to quantify how tax rules affect property values, but it is beyond dispute that when tax benefits are taken away from existing properties, those properties lose value. In 1986, the Tax Reform Act took away numerous benefits associated with ownership of investment real estate. This loss of tax benefits was, in effect, applied retroactively, because it applied not only to new acquisitions, but also to existing properties.

Between 1987 and 1993, the value of the national portfolio of investment real estate fell by 30%. Certainly other non-tax factors contributed to the slide in values, but there is no dispute that the loss of tax benefits for existing property caused the lion's share of the decline. Thus, no matter how generous any transition rule might be, reducing tax benefits for existing property also reduces property values and thereby reduces the value of the equity and savings associated with ownership.

NAR preliminary estimates suggest that if the Panel's mortgage-related proposals were enacted, the value of existing homes would decline by at least 15%, and even more in high-cost areas and second home markets. The loss of deductions increases carrying costs for both residential and commercial property. When carrying costs increase, value either decreases or the pace of growth in value slows. The report of the President's Tax Reform Advisory Panel acknowledges this reality and provides a 5-year transition rule to phase out the mortgage interest deduction for mortgages that are in effect when (if ever) a diminished mortgage interest provision might be enacted. The experience of 1986, however, demonstrates that *no matter how "generous" a transition rule might be, all existing properties will lose value.*

The housing market, while large, is a fragile, delicate instrument. For more than five years, housing has been the most lively and vibrant sector in the economy and fueled much of the 2001 – 2002 economic recovery. Observers will likely find it ironic that, in today's era of low savings, a change to the tax laws could sharply erode the equity savings of homeowners.
We can identify no justification for diminishing the savings families have in their homes.

Conclusion: When former Treasury Secretary James A. Baker III testified before the President's Advisory Panel on Tax Reform in 2005, he made formal comments and also responded to questions about "political realities." In that context, he made this observation about tax reform and the mortgage interest deduction: "[I]f you're going to reform the current income tax code, you will not get there if you think that you're going to be able to eliminate that deduction." (See transcript of hearings held on March 3, 2005, at page 43, posted at www.taxreformpanel.gov.)

We couldn't agree more. Secretary Baker served President Reagan at Treasury during the

arduous deliberations over what became, after nearly two years of debate, the Tax Reform Act of 1986. His observations about tax reform and mortgage interest are based on experience. We underscore them for you.

We have been hard-pressed to make any connections between the President's directive that the Advisory Panel "recognize[e] the importance of homeownership … in American society" and the recommendations the Panel made relative to homeownership. The Panel recommends that the mortgage interest deduction be changed to a tax credit, that it not apply to second homes and that the deduction be tied to a cap that, for some, would cut allowable deductions by more than two-thirds. With these proposals, the Panel strikes a blow *against* homeownership – as well as America's families and communities.