NATIONAL ASSOCIATION OF REALTORS®

The Voice For Real Estate®

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November 16, 2010

The Honorable Erskine Bowles, Co-chair
The Honorable Alan Simpson, Co-chair
National Commission on Fiscal Responsibility and Reform
80 F Street, NW
Washington, DC 20001

Dear Messrs. Bowles and Simpson:

The National Association of REALTORS® (NAR) represents over one million real estate professionals who participate in our organization in their capacities as individuals engaged in real estate businesses. These individuals work as real estate sales agents, brokers, leasing agents, advisors, property managers, developers, commercial and investment real estate specialists and as investors in their own real estate portfolios. Most are self-employed, with business organization forms fairly evenly distributed among Subchapter C corporations, Subchapter S corporations, sole proprietorships, limited liability companies and partnerships.

Historically, the real estate industry has generated between 15% and 18% of the gross domestic product (GDP). During the recession of 2001 – 2003, the real estate sector was one of the only growth sectors in the entire U.S. economy. Even today, and despite serious problems in both the housing and commercial real estate sectors, the industry accounts for about 15% of GDP. Many commentators have stated that we will not return to better economic times unless and until real estate markets, especially housing, stabilize.

We regret that your recent draft has recommended changes to the Mortgage Interest Deduction (MID). One of those concerns is purely pragmatic. We have already heard from some of our members that the coverage of your recommendation about the MID, though it is tentative and not binding, is having a chilling effect on some potential homebuyers. Some consumers already believe that the MID will not be available to them. Your recommendation has sown the seeds of uncertainty as even current owners fear that they will not be able to claim the MID and that their homes will lose even more value.

The purpose of these comments is to remind the Commission of the importance of real estate ownership and investment, and, more specifically, to state our fundamental beliefs about the impact of the federal income tax system on this industry. The ongoing challenges in today's housing sector underscore our sense of urgency about the importance of preserving stability.

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EQUAL HOUSING OPPORTUNITY

Simply stated, we reject tax law changes that would impair Americans' ability to own their homes and to invest in real estate. The current system is well understood and free of the complexities that affect other types of investment.

In these comments, we will briefly discuss housing- and real estate-related aspects of some previous tax reform initiatives. The recommendations of the 2005 Tax Reform Panel are the most specific recommendations made in recent years, and highlight the problems associated with revamping the tax system as it relates to housing and real estate. We will note, as well, the dilemmas of tax law changes for self-employed individuals.

Housing and American Culture

Never dismiss or underestimate Americans' passion for homeownership, notwithstanding the current crisis. Calling homeownership the "American Dream" is not a mere slogan, but rather a bedrock value. Owning a piece of property has been central to American values since Plymouth and Jamestown. Homes are the foundation of our culture, the place where families eat and learn together, the basis for community life. The cottage with a picket fence is an iconic part of our heritage. Do not take that imagery or that passion lightly.

The tax system does not "cause" homeownership. People buy homes to satisfy many social, family and personal goals. The tax system *facilitates* ownership. The tax system supports homeownership by making it more affordable. While it is true that only about one-third of taxpayers itemize deductions in any particular year, it is also true that, over time, substantially more than one third of taxpayers receive the benefit of the mortgage interest deduction. Over time, mortgages get paid off, other new homeowners enter the market and family tax circumstances change. Individuals who utilize the mortgage interest deduction (MID) in years right after a purchase are, over time, likely to switch to the standard deduction.

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. Indeed, in *proportional* terms, the standard deduction could be characterized as a *deeper* subsidy than itemizing taxpayers receive because the standard deduction ($11,400 in the most recent tax year) likely represents and amount that is significantly larger than the individual's total itemized deductions. In essence, the standard deduction, for many, becomes "free" money.

When academics talk about the MID and refer to it as an expenditure, they are speaking in the language of macroeconomics. In reality, the billions of tax dollars they focus on are the individual savings of millions of families. Every time homeowners make a mortgage payment, even in today's market, they are generally creating non-cash wealth. Many of our seasoned Realtors® describe their satisfaction in helping a family secure its first house and then a larger home(s) for raising families. The most satisfying of a long-term series of transactions is helping a couple buy its "last" house *without a mortgage*. Those couples are able to make this "last" purchase because ownership over a long term of years has resulted in savings sufficient to meet their needs.

The federal policy choice to support homeownership has been in the Internal Revenue Code since its inception. We see no valid reason to undermine that basic decision. Indeed, we believe that the only *viable* tax system is one that would continue to nurture homeownership.

Tax System Replacement Models and Housing—The Flat Tax and the National Retail Sales Tax

We recognize that yours is not a tax "reform" panel and that the Commission has no charge to overhaul or replace the current tax system. Nonetheless, we wish to briefly note our views on these models to indicate our passion about them.

NAR aggressively opposed the flat tax as it had been proposed in 1995 by then-Representative Dick Armey (R-TX) and later during the 1996 Presidential primary campaign of Steve Forbes. The Armey-Forbes flat tax, based on the so-called Hall-Rabushka model, would have repealed all deductions, including the mortgage interest deduction and state and local tax deductions. Our internal research and the research of outside experts consistently has shown that *an overnight or even a phased loss of these deductions would cause the value of existing housing to fall by as much as 25%. The average loss of value would be 15%. This is simply unacceptable, particularly because our research also has shown that this loss of value is never fully recouped.*

Under current law, no federal-level tax applies to the purchase of a house. Thus, we would oppose any new, transaction-type tax on the sale or purchase of a house. We have no formal position on the system set forth in the National Retail Sales Tax (H.R. 25, the "Fair Tax"), but we are dismayed that the sales tax rate of that model would likely range between 30 – 45% of the price on a tax-exclusive basis.

We are unable to imagine how buyers, sellers or housing markets could bear the 30 – 45% tax burden of the "Fair Tax." We question whether prudent lenders would or should finance the sales tax cost, as a long-term financing mechanism would almost certainly require mortgages that would exceed the after-tax value of the home. If a home that had been subject to the sales tax were sold before the sales tax liability had been extinguished (which we believe would be the general case), the owner would likely realize no cash, as the outstanding tax and mortgage liabilities could easily use up most or all of the proceeds from the sale. So-called "short sales" would be epidemic. Thus, a tax on home purchase is ill-advised.

2005 Tax Reform Panel Recommendations—Mortgage Interest

A tax reform panel convened by President Bush in 2005 (the 2005 Panel) made a host of recommendations related to housing and real estate tax provisions. We wish to make general comments about them.

Converting the Mortgage Interest Deduction to a Tax Credit: The 2005 panel recommended converting the MID to a 15% tax credit. *In all events, we believe that a change to a tax credit would diminish the value of the existing housing. Following the nationwide declines in home values of recent years, a further diminution of home value caused by the tax system is even more unacceptable.*

This proposal would have created winners and losers: A credit set at such a low percentage would harm individuals in all tax brackets above 15%. A credit set at a higher percent would heavily subsidize those in brackets below the credit amount. NAR's internal research projects during 2005 suggested that, when compared with current law, converting the deduction to a 15% credit created more losers than winners.

The Tax Reform Act of 1986 provided ample evidence that when the tax benefits associated with real estate ownership are curtailed, the value of real estate declines. When the "passive loss" rules

were enacted in 1986, Congress provided five-year transition relief for owners of investment real estate. Nonetheless, *even with the benefit of transition rules,* the loss of value in the commercial real estate sector was 30%. Observers will likely find it ironic that, in today's era of low savings, changing a deduction to a credit would sharply erode savings because of the loss in home values. We can identify no justification for such a diminution.

Reducing the $1 Million Cap on Indebtedness: The $1 million cap on mortgage indebtedness ($1.1 million when home equity debt is included) as a measure of allowable mortgage interest deductions was adopted in 1987. NAR supported that change from prior law, as it was a substantial simplification over the mortgage interest limitations that had been included in the 1986 Tax Reform Act. (Before 1986, there had been no limitation on MID.) *The $1.1 million cap has not been modified or indexed for inflation since 1987.* Given inflation, the overall real economic growth and the normal increases in the cost of housing over ensuing 23 years, we were startled when your draft borrowed from the 2005 Panel and proposed *reducing* the $1.1 million cap.

The 2005 Panel's proposed linking the amount of tax benefits to the FHA loan limits. We believe this proposal would have had very uneven regional and community application. It is unclear how using FHA's community-based formula, based on Metropolitan Statistical Areas, could be transposed fairly into the federal income tax system. We also believe that grafting the FHA system into the tax system would result in extraordinary complexity. Further, we believe that introducing regional differences into the Internal Revenue Code is a dangerous precedent.

Second Homes: The 2005 Panel proposed eliminating tax benefits for second homes. Historically, it has been the general pattern that at least one Congressional district in every state (except Connecticut, where second homes are not concentrated in any particular district), has a lively second home/vacation property market. Eliminating the tax benefits associated with second homes would have a devastating effect in these communities as property values would inevitably fall and local financial institutions that finance second homes would experience significant defaults. Tax benefits have been available for second homes for as long as there has been a mortgage interest deduction.

<u>Other Housing-related 2005 Panel Issues</u>

Housing as a Productive Asset: Professor James Poterba, a member of the 2005 Panel, frequently stated that if less money were invested in owner-occupied housing, more money would be invested in "more productive" assets such as stocks and equipment. *We are aware of no evidence showing that owning stocks, bonds or equipment provides the foundation for vibrant community life or an impetus to encourage good schools, nor does such ownership foster lower crime rates or contribute to the tax base of local governments. Housing does those things.*

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

2005 Panel and Investment Real Estate

Depreciation/Expensing: The 2005 Panel recommended that investments in capital assets be expensed rather than capitalized and depreciated over a term of years. Over the course of the Panel's hearings, no witness specifically addressed whether expensing would extend to real estate. NAR has no formal position on expensing but does recommend that the Committee use caution when recommending the appropriate model for real estate cost recovery.

Expensing real estate would create a very front-loaded investment regime for this long-lived asset. In the recent past, the commercial and investment real estate industry, always cyclical, demonstrated the limitations of a cost recovery system that is too heavily front-loaded. The so-called "10-5-3" proposal emerged in 1981 to enhance capital formation and investment in a sluggish economy. Under that proposal, investments in real estate would have been capitalized and costs recovered over 10 years.

While real estate professionals accepted a 10-year recovery period for manufacturing plant and owner-occupied properties, the investment real estate sector believed that a 10-year cost recovery period was overly generous and could lead to distortion and speculation in the marketplace. In the end, the Economic Recovery Tax Act of 1981 established a 15-year cost recovery period for all real estate. The recovery period was increased to 18 years in 1984 and 19 years in 1985. The predicted speculation and abuse occurred.

The Tax Reform Act of 1986 radically changed the tax model for real estate investment, lengthening the cost recovery period to 31.5 years for nonresidential real estate (increased to 39 years in 1993) and 27.5 years for residential property. Moreover, to curtail the tax shelter industry that had grown up around real estate, the 1986 Act implemented the exceptionally complex, onerous and poorly understood passive loss rules.

NAR has no interest in repeating the scenario in which overly generous benefits are given to the industry, then abused, then abruptly removed. In 1986, the draconian changes to real estate taxation, the failure to provide protection for existing assets and the absence of realistic transition rules combined to cause severe dislocation and loss of value to investment property and grave danger to the financial system. *NAR has no position that would support or reject expensing.* NAR does, however, wish to remind the Committee that real estate investment has unique characteristics. Poorly designed cost recovery rules for real estate can distort investment and generate abusive investor behavior.

Interest Expense: Investment real estate is almost always acquired with debt. During the early 1980's, the debt to equity ratios were considerably higher than they are today and contributed to the harsh outcomes of the 1986 Act. Under current market practice, investors generally have equity in their projects ranging between 30 and 40%, with some owners investing as much as 50% equity. Nonetheless, leverage and interest expense deductions are intrinsic to real estate investment.

We acknowledge that a theoretical tax model that might permit expensing of capital investment would likely eliminate interest deductions. As a general matter, we would oppose elimination of deductions for interest expense. We believe that cost recovery periods and interest expense provisions should adhere to principles related to matching of income and expenses.

Self-employed Persons

At the intersection of business taxation and individual taxation is a self-employed person who must comply with both regimes. Thus, the self-employed person, even a real estate sole proprietor with no inventory and a business that relies mostly on cash payment, always faces more complexities than other taxpayers in measuring income, distinguishing personal and business use of various assets, achieving full tax compliance and satisfying payroll tax obligations. We note with pride that Realtors® have generally achieved high rates of compliance among the self-employed because of current law statutory protections that clarify the relationship between brokers and real estate sales agents. We urge your Commission to acknowledge the complexity of the tax system as it affects self-employed individuals and do nothing that would further complicate compliance.

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The National Association of REALTORS® appreciates this opportunity to comment. Should you wish to discuss any real estate tax issues or questions these comments suggest, you may contact Linda Goold, NAR's Tax Counsel, at 202-383-1083.

Sincerely,

Ron Phipps, ABR, CRS, GRI, GREEN, e-PRO
2011 President
National Association of REALTORS®

Cc: Members, Tax Reform Working Group