Testimony of

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On Behalf of the National Association of Home Builders

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Hearing on

"The Role of Tax Incentives in Affordable Housing"

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On behalf of the more than 140,000 members of the National Association of Home Builders (NAHB), I am Jerry Konter, NAHB's 2022 Chairman of the Board and founder and president of Konter Quality Homes, based in Savannah, Georgia. Over my career, my company has built more than 2,200 single-family and 700 multifamily homes.

The Internal Revenue Code currently provides numerous housing-related rules and incentives covering both owner-occupied and rental units. There are key tax provisions geared toward rental housing, which help facilitate the production of new rental housing. These include the Low-Income Housing Tax Credit (LIHTC); accelerated depreciation; Section 142 multifamily rental bonds; and carried interest.

There are also several owner-occupied housing tax incentives that help make owning a home affordable and accessible to millions of Americans. These include the mortgage interest deduction (MID); the deduction for local property taxes; the principal residence capital gains exclusion; and mortgage revenue bonds.

NAHB has spent years researching the housing tax incentives to determine how they benefit builders, remodelers, homebuyers, home owners, and renters. Many assumptions are made about various housing policies. NAHB has sought to move away from assumptions to a fact-based approach as we evaluate these tax incentives to ensure these long-standing tax incentives are effective. My testimony explores the lessons learned from that research.

Many of these incentives continue to serve the public interest and remain highly effective, including LIHTC, which should be further expanded to reflect the need for more affordable rental housing as well as increases in development costs.

On the other hand, some housing tax incentives have failed to keep up with changes to the tax code. What was once an effective tax incentive may no longer be serving its original purpose—we would put forward the mortgage interest deduction as an example of a housing incentive that should be updated to reflect today's tax code and better serve the segment of prospective home owners that face unprecedented affordability challenges.

The housing affordability crisis is driven by one fact: over the past decade, we have failed to produce enough housing to keep up with demand. If we are going to solve our housing affordability crisis, we must drive down the cost to build as well as the cost to own or rent. Well-structured housing tax incentives can help us achieve this goal. With the specter of a recession looming over the economy, production-focused incentives have the potential to help housing recovery quickly and help reduce inflationary pressures.

Indeed, shelter-based inflation, which makes up 40% of the CPI, increased in June at the fastest pace since 1986.[1] While the Federal Reserve is increasing interest rates via tighter monetary policy to fight inflation, its policy tools are poorly situated for addressing the housing element of the inflation challenge. Higher interest rates increase the cost of buying a home (thus increasing demand for rental housing and generating higher rents), while also increasing the cost of financing single-family and multifamily construction, thereby restricting housing supply. Only

[1] https://eyeonhousing.org/2022/07/june-inflation-reading-the-highest-since-1981/

efficient, timely and targeted finance and tax policy can address the root causes of underbuilding in the U.S., thereby tackling the shelter-based source of inflation.

Given this economic backdrop, NAHB specifically recommends:

- Expanding resources for the Low-Income Housing Tax Credit by enacting the Affordable Housing Credit Improvement Act (S. 1136). LIHTC is the most effective tool to boost production of affordable rental housing. We appreciate the leadership of Senator Cantwell, Chairman Wyden, Senator Young and Senator Portman, along withthe many members of this Committee who have cosponsored this legislation.
- Enacting the Middle-Income Housing Tax Credit as proposed by Chairman Wyden as part of the Decent, Affordable, Safe Housing for All (DASH) Act. LIHTC typically helps finance projects serving residents earning up to 60% of the Area Median Income. MIHTC would pick up where LIHTC stops by helping to finance the construction of affordable rental projects serving residents earning 60% to 100% of AMI.
- Revisiting the homeownership tax incentives. The mortgage interest deduction has been a cornerstone of the tax code since the code's inception, but recent tax data suggests the MID is no longer an effective means to promote homeownership. NAHB supports converting the MID into a targeted and ongoing homeownership tax credit which could be claimed against mortgage interest and property taxes paid. This testimony includes detailed policy recommendations on how to structure a credit that is targeted, increases progressivity in the tax code, and promotes housing opportunity by providing a tax incentive more accessible to minority and first-generation home buyers.
- Responding to inflation by indexing the homeownership tax incentives. The existing mortgage interest deduction limit on acquisition debt has never been indexed to inflation. The capital gains exclusion also has not been adjusted for inflation. This is slowly eroding the value of these incentives, and Congress should move to begin indexing these limits to inflation immediately.
- Reconsidering the current limits on the SALT deduction. For high-cost as well as high-tax states, the $10,000 deduction limit effectively increases the ongoing costs of owning a home by denying home owners a full deduction of their property and other state and local taxes. Under the principle that taxes paid to state and local governments should not be double-taxed as income by the federal government, NAHB supports eliminating the SALT deduction cap.

Balance Between Rental Policies and Owner-Occupied Policies

Questions are frequently raised whether there is a balanced policy between rental and owner-occupied housing. There exists justifiable reasons to support both forms of housing with policy – be it to ensure the availability of high quality, affordable rental housing or to support homeownership and unleash the well-documented positive externalities that benefit entire communities. However, there is, in some circles, an assumption that renters are getting the short end of the stick.

NAHB has looked at the tax and spending policies that affect both rental and owner-occupied housing: the mortgage interest deduction; the real estate tax deduction; capital gains exclusion;

mortgage revenue bonds; Section 108 relief; and HOME, CDGB, USDA, and other appropriations. According to numbers published by the Joint Committee on Taxation (JCT) for 2020 and the Congressional Research Service (CRS) for Fiscal Year 2018, federal owner-occupied housing support totaled $86.8 billion.

NAHB also looked at policies supporting rental housing: Low Income Housing Tax Credit; accelerated depreciation on rental housing; bonds; like-kind exchanges; the historic credit; tenant-based and project-based Section 8; public housing funding; and other appropriations such as HOME, CDBG, and USDA. According to numbers published by the Joint Committee on Taxation (JCT) and the Congressional Research Service (CRS) for Fiscal Year 2018, rental housing support totaled $84.9 billion.

To determine if the appropriate policy balance has been struck, it is necessary to look at the U.S. population share living in each type of housing. Based on the numbers above, 49.2 percent of the policy support goes towards owner-occupied housing; 64.4 percent of the U.S. population lives in owner-occupied housing, according to the 2020 American Community Survey. In comparison, 50.8% of the policy support is targeted to rental housing; 35.6% of the U.S. population lives in rental housing.

Based on the population living in each type of housing, the data indicates that policy support between rental and owner-occupied housing is currently tilted toward rental housing. NAHB is forecasting declines for the homeownership rate in the quarters ahead. As such, this current state of policy balanced needs addressing given the current economic environment.

Affordable Housing Development Requires Policy Support

To understand what is needed to address the affordable housing crisis, policymakers need to understand the challenges facing the development community.

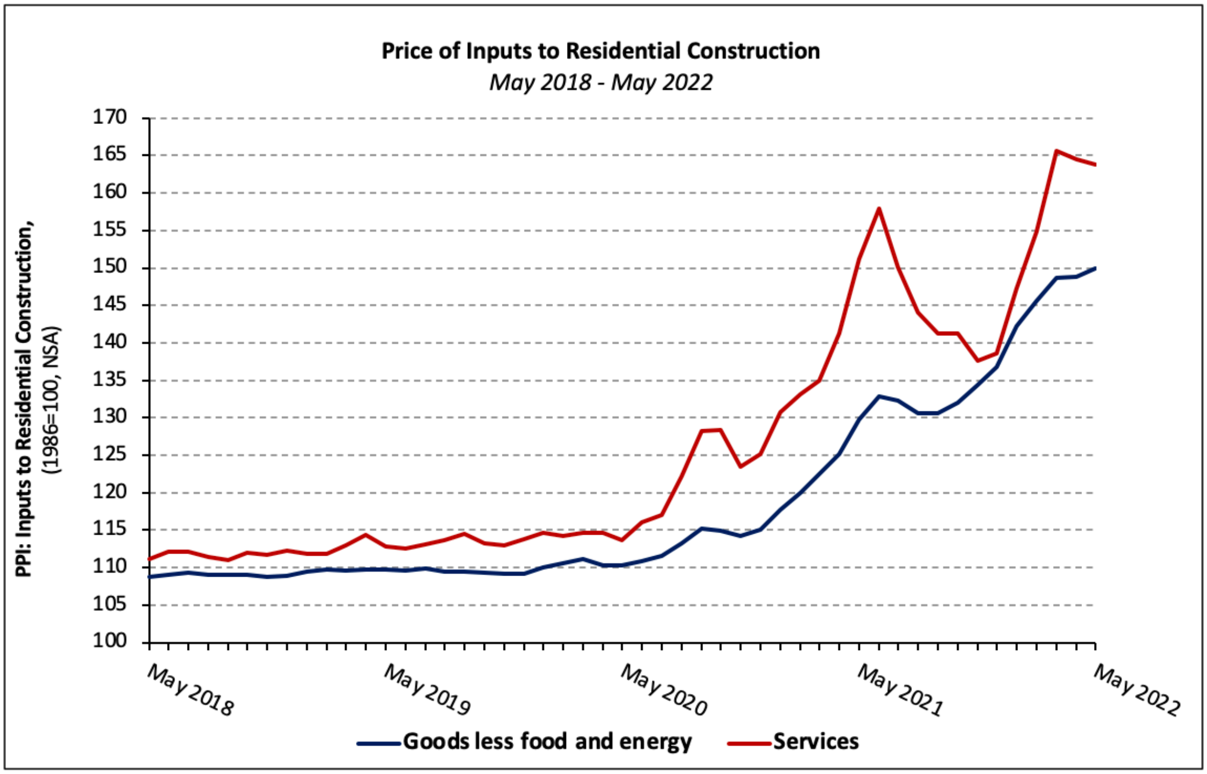
Where there is growing housing demand, the nation's home builders want to supply inventory to meet that demand. But there is no magic wand to erase basic development costs. Fees, regulatory compliance, modern building and energy codes, building materials, land and labor costs determine whether a project is financially viable. And if we want to provide affordable rental housing for lower-income households, it is financially impossible to do so without a subsidy.

There is a persistent misperception that developers only seek to build higher-end projects. The reality is developers face a pricing floor driven by basic development costs that they cannot control. NAHB estimates that 69% of American households cannot afford the median priced new home.[2] That is alarming.

Home builders are not ignoring 70% of the marketplace—development costs simply make it impossible to produce more affordable offerings. Building material prices collectively are up

[2] https://www.nahb.org/news-and-economics/housing-economics/housings-economic-impact/households-priced-out-by-higher-house-prices-and-interest-rates

19.2% year-over-year and 35.6% since the start of the pandemic.[3] Since the spring of 2020, lumber prices are up 75%; steel mill prices are up 107%; gypsum/drywall is up 32%; ready-mix concrete is up 11%; interior paint is up 33% and exterior paint is up 48%; aluminum is up 61%; and copper is up 57%.



It comes as no surprise that the median price of a newly built, single-family home increased 19.7% year-over-year. This country was already facing a housing affordability crisis, but the inflationary effects of the building material price increases are squeezing home buyers even more. A year ago, 23% of new home sales were priced below $300,000. In May, it was only 10%.[4] We have now seen housing affordability fall to a decade-plus low.[5]

Solving this challenge will only be possible if federal, state, and local governments work together to remove barriers to new construction and create effective incentives to promote affordable housing opportunities.

While tax incentives can help create an affordable and accessible housing marketplace, which includes access to both rental housing as well as owner-occupied housing, Congress must consider all the policy decisions that have brought us to where we are today. Within NAHB, we often refer to the "Five L's" as shorthand for the headwinds facing the industry: labor; lending;

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[3] https://www.nahb.org/blog/2022/05/building-materials-up-more-than-19-percent-year-over-year

[4] https://eyeonhousing.org/2022/06/new-home-sales-increase-in-may-before-feds-june-rate-rise/

[5] https://www.nahb.org/news-and-economics/press-releases/2022/05/new-home-sales-down-on-rising-interest-rates-declining-affordability

local regulatory restrictions; lots; and lumber. In the past 18 months, the headwinds have begun to turn into gale force blasts.

We also need to recognize the important role affordable housing plays in our communities. Breaking the cycle of poverty starts with access to stable and affordable housing. There are meaningful social effects. Even after 40 years in this business, I still enjoy nothing more than handing over the keys to a customer buying their first home. As a multifamily developer, I also understand how affordable rental housing creates stability for my tenants and their families.

The housing affordability crisis affects our economy as well. It costs us jobs, productivity, and economic growth. I challenge everyone in this room to ask the owners of the small businesses you frequent about labor shortages. Housing affordability is critical in areas of the country experiencing robust economic growth. As the number of open, unfilled jobs grows, the operation of the housing market plays a key role in allowing individuals to relocate to areas where jobs need to be filled. And if we don't address this issue, where do our employers find their workers? How do we grow the economy?

And for our fellow citizens who want to realize the American dream, if they cannot afford to live where the economic opportunities are, we are just creating an economic divide based on housing "have's" and "have nots."

Owner-Occupied Tax Policies

The Benefits of Homeownership

Homeownership offers a wide range of benefits to individuals and households.[6] These include increased wealth accumulation, improved labor market outcomes, better mental and physical health, increased financial and physical health for seniors, reduced rates of divorce, and improved school performance and development of children. These beneficial financial and social outcomes are due to the stability offered by homeownership, as well as the incentives created by the process and responsibilities of becoming and remaining a homeowner.

An important motivating factor in the pursuit of homeownership is the investment opportunity it offers for many families. Equity in a home constitutes a substantial proportion of a typical American family's wealth. According to the 2019 Federal Reserve Survey of Consumer Finances (SCF), the median family net worth of a home owner was $255,000; for renters, it was $6,300.

Homeownership also provides advantages for seniors. A significant proportion of a household's wealth is in the form of equity of owner-occupied housing, and this wealth provides significant advantages in retirement. Mayer and Simons (1994) indicate that equity in the home and the use of a reverse mortgage could increase liquidity for senior households by as much as 200%.[7]

[6] R.D. Dietz and D.R. Haurin, The social and private micro-level consequences of homeownership, Journal of Urban Economics 54 (2003) 401-50.
[7] C. J. Mayer, K. V. Simons, Reverse mortgages and the liquidity of housing wealth, AREUEA Journal 22 (1994) 235-55.

These data illustrate the importance of housing wealth and suggest caution with respect to policies that would reduce these wealth holdings, based on decisions made over a lifetime, via direct policy changes (such as weakening the section 121 gain exclusion for principal residences) or indirect changes (such as price declines induced by weakening the mortgage interest deduction).

Overall, economists, sociologists and other social scientists have found significant, positive homeownership-related impacts on a large set of outcomes associated with households and communities.[8] For these and other positive impacts, homeownership has and should continue to have a favorable place in the tax code.

Mortgage Interest Deduction

Brief History of the Mortgage Interest Deduction

When Congress created the modern income tax code in 1913, Congress recognized the importance of allowing for the deduction of interest paid on debt incurred in the generation of income. In this early code, taxpayers were permitted to deduct a wide array of interest types from business and personal debts, including mortgage interest. The mortgage interest deduction came into its own after World War II, when home ownership became more accessible and a rite of passage for the middle class. Deductions for mortgage interest grew in absolute numbers, homeownership rates increased during this period, and today two-thirds of American households own a home.[9]

In reforming the tax code in 1986, Congress disallowed the deduction of interest payments for certain types of debt but maintained the popular deduction for mortgage interest. In doing so, "…Congress nevertheless determined that encouraging home ownership is an important policy goal, achieved in part by providing a deduction for residential mortgage interest."[10] Aside from some adjustments in 1987, the mortgage interest deduction remained unchanged until 2017.

The $1 Million Cap and Limits to the Mortgage Interest Deduction

Starting with the first tax code in 1913, there was no limit on the amount of home mortgage interest that could be deducted. However, the *Tax Reform Act of 1986* imposed limits on the deduction. This law limited the deduction to interest allocable to debt used to purchase, construct or improve (acquisition debt) a designated primary residence and one other residence.

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[8] Two comprehensive literature reviews detailing the impacts of homeownership are:
W. M. Rohe, G. McCarthy, S. Van Zandt, The social benefits and costs of homeownership: A critical assessment of the research, Research Institute for Housing America, Working Paper No. 00-01 (2000).
R. Dietz and D. Haurin, The social and private micro-level consequences of homeownership, Journal of Urban Economics 54 (2003) 401-50.

[9] https://eyeonhousing.org/2022/04/homeownership-rate-stable-at-65-4/

[10] "General Explanation of the Tax Reform Act of 1986", Joint Committee Print, Prepared by the Staff of the Joint Committee on Taxation, May 4, 1987. Pg 263-264.

The Omnibus Budget Reconciliation Act of 1987 further limited the deduction to interest allocable to up to $1 million in acquisition debt. This limit is not adjusted for inflation. Factoring in the effect of inflation, the value of the cap has eroded by more than half since 1987; in 2022 dollars, the original cap would be equal to just over $2.5 million.[11]

The acquisition debt cap was further reduced under the *Tax Cuts and Jobs Act* (TCJA). TCJA reduced the acquisition cap to $750,000 and eliminated the separate $100,000 deduction for home equity loan debt. Home owners may continue to deduct home equity debt if it is used to substantially improve an eligible home and the total amount of mortgage and home equity debt does not exceed $750,000.[12]

Under current law, the acquisition debt limit will be restored to $1 million and the separate deduction for home equity loans will return after December 31, 2025.

Absent an inflation adjustment, and with rising home prices, NAHB anticipates a growing number of home owners with a mortgage will begin to bump up against the cap, especially if Congress elects to extend the current $750,000 threshold. The median new home sale price was $449,000 in May, a 15% increase since last May. And even prior to the current high-pace of price increases, a growing share of housing units were valued between $500,000 and $1 million.

	2015	**2020**
Total Owner-occupied Units	74,712,091	78,801,376
Less than $300K	63.6%	63.5%
$300K-$500K	15.8%	20.5%
$500K-$1M	8.4%	12.3%
>$1M	2.2%	3.7%
Number of Homes Valued at $500K+	7,919,482	12,608,220
Increase		4,688,739

NAHB strongly believes that the acquisition debt cap must be indexed for inflation to ensure that home buyers in high-cost areas have the same opportunities as those in more affordable areas.

[11] Bureau of Labor Statistics CPI Inflation Calculator. $1,000,000 in 1987 equates to $2,528,309 in 2022. http://www.bls.gov/data/inflation_calculator.htm

[12] https://www.irs.gov/newsroom/interest-on-home-equity-loans-often-still-deductible-under-new-law

The Tax Code has Evolved, but the Mortgage Interest Deduction Has Not: Rethinking How Homeownership is Incentivized

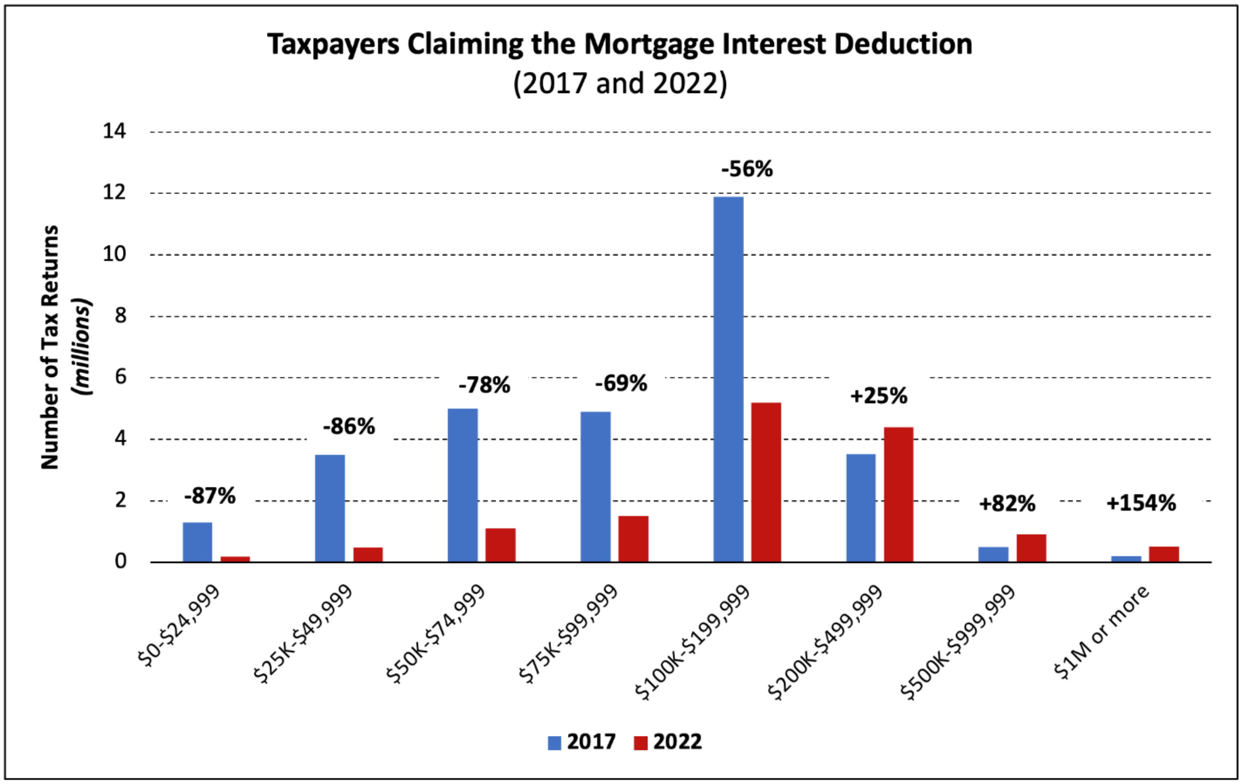
The mortgage interest deduction proved to be an effective tool to reduce the ongoing costs of homeownership—and make homeownership more accessible and affordable—for over 100 years. But the MID remains firmly rooted in an increasingly outdated section of the tax code: itemized deductions. The changes brought by TCJA, namely doubling the standard deduction, significantly reduced the number of taxpayers who itemize. Perhaps more important to the ongoing policy debate, of the remaining itemizers, today's itemizing taxpayers tend to be more wealthy than non-itemizers.

Prior to TCJA, typically 70% of home owners with a mortgage claimed the MID. And according to distributional tax expenditure estimates from the Joint Committee on Taxation (JCT), 86% of mortgage interest deduction beneficiaries earned less than $200,000 in economic income. The MID was also a progressive element in the tax code. 65% of the net tax benefits were collected by home owners with economic income of less than $200,000, yet these same taxpayers paid only about 40% of all income taxes.[13]

This is no longer the case today. Recent IRS data indicate that only 26.7% of home owners with a mortgage now claim the MID.[14] This is consistent with the overall decline in itemizing taxpayers. In 2017, 32% of taxpayers itemized deductions; according to the Joint Committee on Taxation, approximately 12% of taxpayers will itemize in 2022. And that same IRS data suggests that the key target population of the MID—first-time home buyers and younger families looking to move up—have likely shifted away from claiming the MID and instead claim the standard deduction.

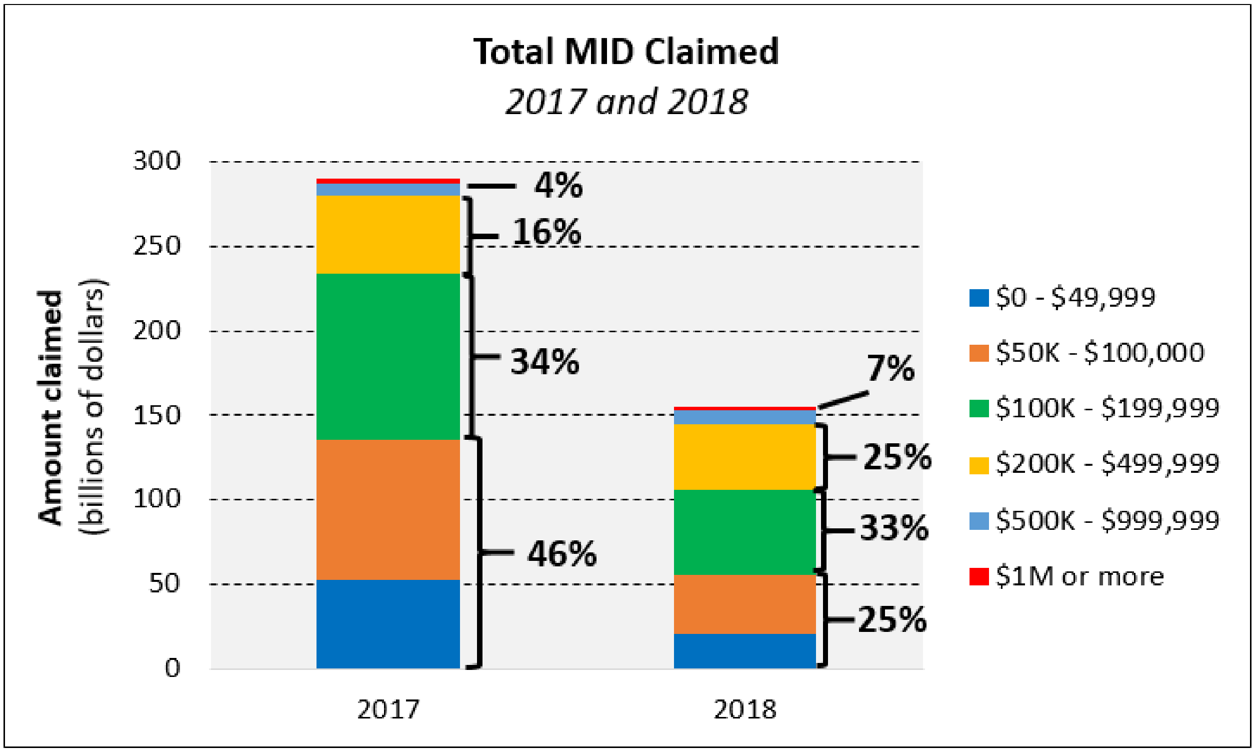
[13] Estimates of Federal Tax Expenditures for Fiscal Years 2012 – 2017.
https://www.jct.gov/publications.html?func=startdown&id=4504

[14] In 2020, there were 48,974,364 owner-occupied units with a mortgage and 13,067,000 MID claimants.



The IRS data reveal this shift when comparing taxpayers claiming the MID in 2017 and 2022.[15] The number of taxpayers claiming the MID with income below 200,000 dramatically fell, while those earning more than $200,000 continued to benefit.

[15] 2022 data is based on the Joint Committee on Taxation's July 11, 2022, report, JCX-15-22



And using IRS data to examine the total amount of MID claims in 2017 and 2018, two effects of the increased standard deduction are evident. First, total deductions were reduced by nearly half. This is a sizeable retreat in homeownership support through the tax code.

Second, the negative income distribution effects are laid bare. In 2017, 80% of the MID amount deducted was deducted by taxpayers earning less than $200k. In 2018, that fell to 58%.

This wealth disparity is particularly acute when viewed within the context of minority homeownership rates. In the first quarter of 2022, the homeownership rate was 65.2% among all U.S. households. But the range is large among races. Among white households the rate was 73.8% while it was 59.4%, 49.1%, and 43.1% for Asian, Hispanic, and African-American households, respectively.[16]

Although the lifecycle patterns of homeownership by race and ethnicity are similar, with homeownership becoming more likely with age, the share of households owning a home differs significantly based on race and ethnicity. Of white households under the age of 35, 46% owned a home; only 17% of African American households owned a home.[17]

[16] https://fredblog.stlouisfed.org/2022/04/the-latest-on-homeownership-race-and-region/?utm_source=series_page&utm_medium=related_content&utm_term=related_resources&utm_campaign=fredblog

[17] https://www.federalreserve.gov/econres/notes/feds-notes/disparities-in-wealth-by-race-and-ethnicity-in-the-2019-survey-of-consumer-finances-20200928.htm

To some degree, this gap can be linked to generational wealth transfers, with white families more likely to receive financial support from parents. In looking at this effect, a 2020 paper on disparities in wealth and ethnicity observes this dynamic of family wealth:

> The relationship between housing and family wealth is complex. On the one hand, the ability to purchase a home is a reflection of wealth a family already has (or their parents' wealth, as noted earlier), as significant funds are generally required for a down payment and closing costs. On the other hand, homeownership has also been found to yield strong financial returns on average and to be a key channel through which families build wealth.[18]

The financial challenges of accumulating a down payment and adequate savings for closing costs is one reason why minority homeownership rates lag.

<u>Family Size Matters</u>

The lifecycle aspects of homeownership also produce another interaction with housing tax preferences. It is often claimed that the mortgage interest deduction encourages home owners to purchase a larger home. This presents a rather narrow view.

Home owners with a larger family need a larger home and will therefore have a large mortgage interest deduction. The need for a larger home created the larger mortgage interest deduction, not the other way around. And NAHB analysis of SOI data confirms this.[19] Taxpayers with two exemptions – a proxy for size - who claimed the MID had an average tax benefit of $1,500. Taxpayers with four exemptions had an average benefit of approximately $1,950. In fact, the benefit increased correspondingly from one exemption to five-plus exemptions, which is intuitive with the notion that larger families require larger homes.[20]

Moreover, the cost of living, particularly for housing, varies greatly from city to city, so what may appear to be a large deduction for a given home in one area, may in fact reflect a modest home in a high-cost area. Indeed, the MID and the real estate tax deductions reflect one of the few elements in the tax code that account for differences in cost-of-living.

<u>And Age Matters</u>

Along with the lifecycle associated with family size, we also see a direct correlation between the age of the home owner and their resulting benefit from the housing tax incentives. Unlike other itemized deductions, the total benefits of housing-related deductions, such as the mortgage

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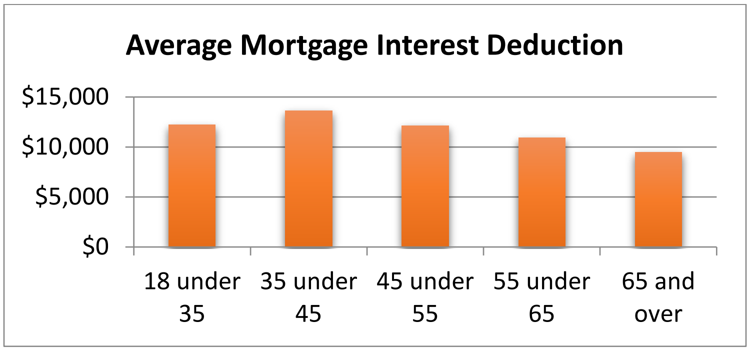
[18] https://www.federalreserve.gov/econres/notes/feds-notes/disparities-in-wealth-by-race-and-ethnicity-in-the-2019-survey-of-consumer-finances-20200928.htm

[19] Who Benefits from the Housing Tax Deductions? http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=150471&channelID=311

[20] The data also show that income rises with the number exemptions for those claiming the MID. For taxpayers with AGI less than $50,000 who claim the MID, the mean number of exemptions was 2.01 in 2004. It was 2.57 for those with AGI $50,000 to $75,000, 2.89 for those with $75,000 to $100,000 in AGI, and 2.98 for those between AGI $100,000 and $200,000 and 3.03 for those above these AGI levels.

interest deduction, generally *decline* with age. After all, it is younger households who typically have new mortgages, less equity, and growing families.

Using IRS data, NAHB has examined the age characteristics of taxpayers claiming the mortgage interest deduction. The chart below plots the average mortgage interest deduction[21] by age cohort.



This is consistent with the deduction for mortgage interest peaking soon after the taxpayer moves from renting to homeowning and then declines as home owners pay down their existing mortgage debt.

NAHB believes that any policy change that makes it harder to buy a home or delays the purchase of the home until an older age, will have significant long-term impacts on household wealth accumulation and the makeup of the middle class. Delayed investment in homeownership may translate into lower assets at retirement or a later retirement.

Traditionally, the MID offered large benefits, as a share of household income, for younger home owners. With fewer taxpayers itemizing and claiming the MID, the lack of a meaningful homeownership tax incentive means shutting out younger, aspiring middle class Americans from homeownership, which could have far-reaching social and economic outcomes.

<u>Creating a More Equitable and Effective Homeownership Tax Incentive</u>

Efficacy of homeownership tax incentives should be measured by whether they benefit lower- and middle-income first-time buyers as well as younger buyers looking to move up the ladder. The homeownership tax incentives should equally benefit minority households whose homeownership rates have consistently trailed white households.

As the data above indicates, shifts away from itemization have resulted in fewer itemizing taxpayers, but those taxpayers who continue to itemize tend to have higher incomes. As a consequence, the MID is now missing the mark. NAHB believes that the trend toward less itemization, and a higher standard deduction, which results in a simpler, more progressive tax code, is likely to stay.

[21] This reflects claims prior to TCJA and includes the deduction for home equity loans.

Prior to House passage of the *Tax Cuts and Jobs Act*, NAHB proposed a new approach to incentivizing homeownership. We believe the most effective way to promote and enable homeownership is to eliminate the mortgage interest deduction and replace it with a simplified and targeted tax credit.

Specifically, NAHB supports a 15% tax credit claimed against mortgage interest paid on up to $750,000 of acquisition debt plus state and local real estate taxes paid would offer a more effective and progressive tax incentive. To ensure the credit targets those who need financial assistance, but also reflecting the regional variations in home prices throughout the country, we believe the credit should be phased-out for single-filers with incomes above $250,000 and joint-filers with income above $500,000.

Unlike current law, NAHB strongly believes the acquisition debt limit, along with the income phase-outs, must be adjusted for inflation. We also support retaining the present treatment of second homes.

NAHB believes a credit structured along these lines can be enacted on a revenue-neutral basis starting with the 2026 tax year.

A credit designed in this manner brings additional benefits to homebuyers: fairness along with predictability via simplicity. With every deduction, the tax benefit varies with the taxpayer's marginal tax rate. As a result, taxpayers with higher income receive a larger tax benefit, which is often raised as a criticism of the existing MID. A credit ensures parity amongst eligible taxpayers.

A credit also has the upside of being easy to calculate, which would allow homebuyers to predict their tax benefits. Under the current system, homebuyers must first determine that they will itemize and then calculate the additional value of the itemized deductions in excess of the standard deduction they would have otherwise claimed in order to determine the value received from the MID.

For many homebuyers, they simply know they will get some tax benefit under the MID, or perhaps have a rough sense of the dollar value. With a credit, this process is greatly simplified, and it will allow prospective homebuyers to easily determine what their ongoing ownership costs will be.

A targeted, ongoing, easy-to-claim credit based on mortgage interest and property taxes paid would direct the homeownership tax incentives to those who most need it: middle-class and lower-income Americans from all backgrounds.

Second Homes and the Mortgage Interest Deduction

<u>Tax Rules for the Second Home</u>

Home owners may deduct interest payments on up to two homes in a given tax year: a primary residence and one other residence. The amount that may be deducted is limited to the combined cap of $750,000 in acquisition debt. A second home is one that is not rented[22] and is not the home owner's primary residence. In addition, a second home can also be a home under construction for which the home owner has an outstanding construction loan.

When is a Second Home Not a Second Home?

In practice, the second home deduction is important for many households who in fact do not think of themselves as owning two homes. For example, the second home deduction facilitates claiming the mortgage interest deduction during a period of homeownership transition, such as when a family relocates and will own two separate principal residences in a given tax year—even if both homes are not owned concurrently. Without the second home MID, this family would only be able to claim an interest deduction on a portion of their total mortgage interest payment. This would not only act as a tax on moving, but it could distort consumer behavior by discouraging relocation or leading to home owners moving only at the start or end of a tax year in order to minimize the tax implications.

Further, the second home rules allow up to 24 months of construction loan interest on a newly constructed home to be claimed while the family resides in their existing principal residence.[23] This rule provides parity for custom home building where the eventual home owner finances the cost of construction. While both of these issues are technical and easily fixed as part of a transition, NAHB raises them for consideration because no reform proposal that eliminates the second home deduction has ever considered the implications on home owners who move or take on a construction loan.

The Geographic Distribution of Second Homes

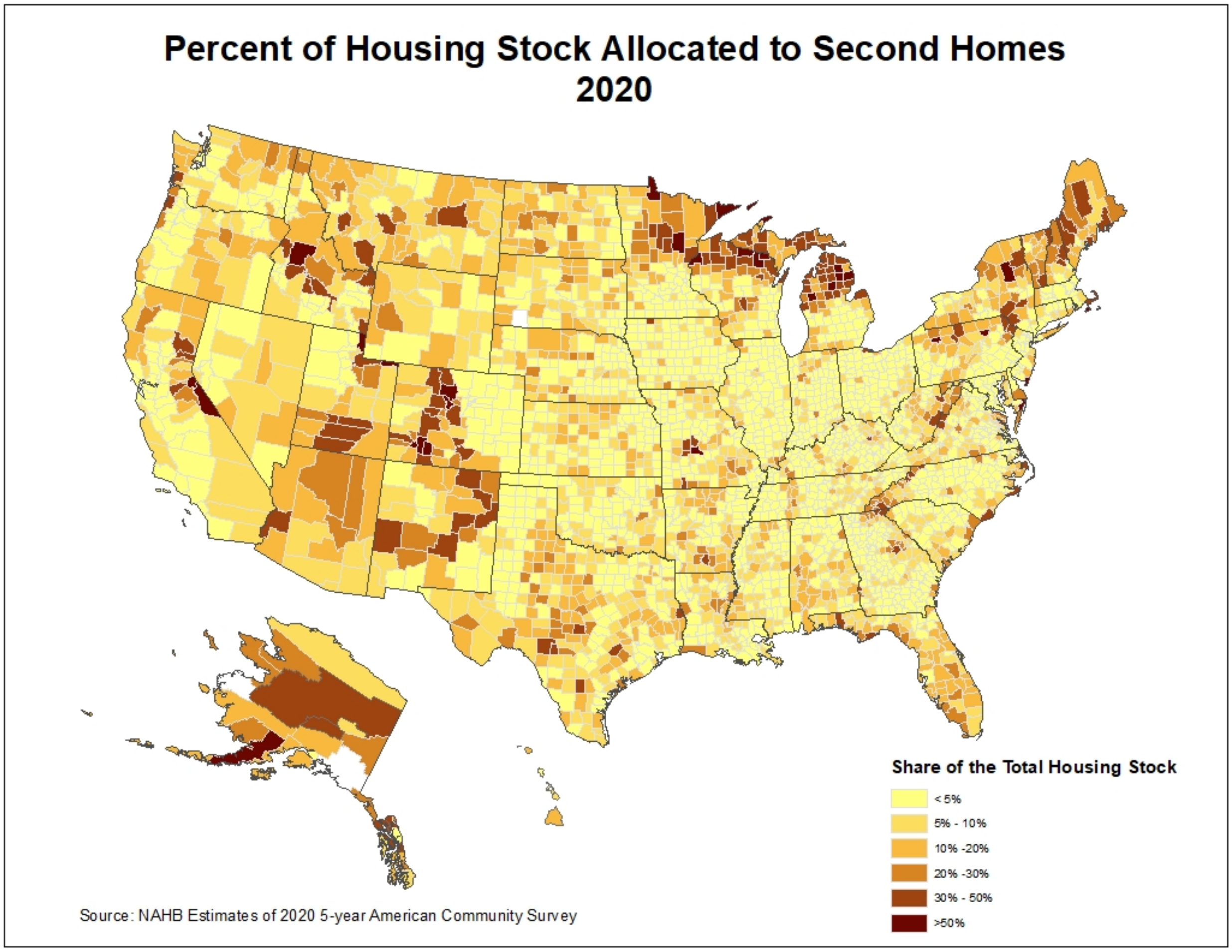
When most Americans think of second homes, thoughts typically go to expensive beach homes. However, such homes are more likely to be owned by higher-income families who own the home free and clear of a mortgage—or rent out the home, in which case the owner does not claim the mortgage interest deduction. The face of the typical second home owner is more varied than most realize.

Using Census data, NAHB estimated the stock and share of such tax definition-based second homes and the results contrast with the stereotyped view of the second home mortgage interest deduction favoring beach homes. Nearly every state has areas with significant numbers of second homes; 49 states have a county where at least 10 percent of the housing stock consists of second homes.[24] As the next map shows, second homes are found throughout the country.

[22] Interest on debt used to acquire rental units may also in general be deducted under the tax code, but not under the mortgage interest deduction; it is a general business expense.

[23] Treasury Regulations 1.163.

[24] Connecticut is the only state that did not have at least one county where 10 percent of the housing stock was a second home.



An examination of the geographic location of second homes also shows that many second homes are in areas of the country that are generally affordable. Half of the nation's second homes can be found in eight states: Florida; California; New York; Texas; Michigan; North Carolina; Arizona; and Pennsylvania. An in-depth analysis of the county level data shows that the concentration of second homes expands beyond beachfront locations. Fifteen states have at least one county with at least half their housing stock as second homes. This includes six counties in Michigan, five in Colorado, four in Wisconsin, three in Minnesota, two in Alaska, Utah, California, and Massachusetts, and one county in New York, Idaho, Missouri, Maryland, New Jersey, and Texas.[25]

Clearly, the issue concerning second homes and the mortgage interest deduction is more complicated than many expect. Repeal of the second home mortgage interest deduction rules would impact large sections of the country and nearly every state. There would be negative economic consequences throughout the nation in terms of lost home sales, home construction, as well as price impacts. And those price declines would of course be more significantly realized in those areas of the country for which second homeownership is more common. As home values

[25] https://eyeonhousing.org/2022/05/the-nations-stock-of-second-homes/

directly correlate with property taxes, repealing the second home mortgage interest deduction would not just touch the home owner, but the broader community, as local governments would face additional revenue shortfalls. This is particularly important as many impacted communities lack a diverse tax base, and second home owners are the ideal taxpayers, often paying a higher property tax rate while not placing heavy demands on local government services.

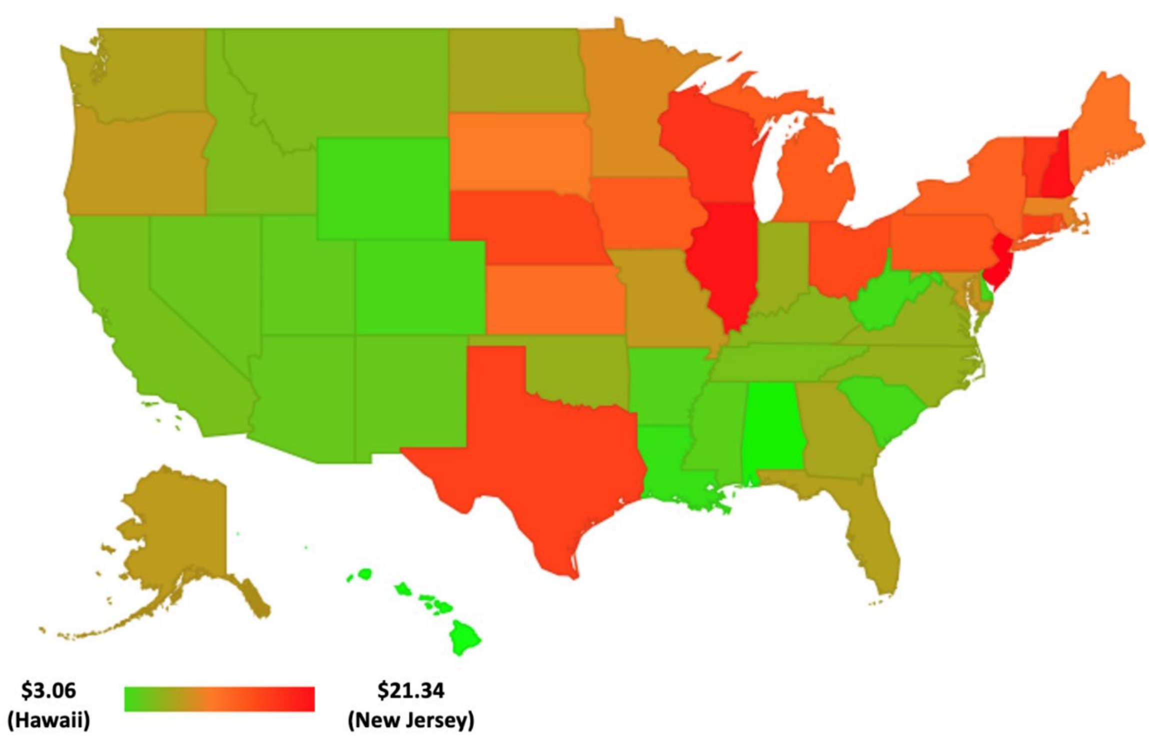
State and Local Real Estate Deduction

Brief History of the State and Local Real Estate Tax Deduction

The deductibility of state and local real estate taxes has been part of the tax code since the U.S. income tax code was enacted in 1913. This deduction aligns with a general principle of fair taxation: taxes paid to a local or state government should not be taxed as income by the federal government. If the goal of an income tax regime is to tax changes in wealth, income which is ultimately paid out as a tax does not represent a change in wealth.

Housing is taxed in many ways unlike other investments, particularly via property taxes. While other investments are taxed when sold and the tax is based on their gain in value, housing is the only investment which is taxed annually on the value of that investment, irrespective of any increase in value. This tax burden faced by home owners is often lost in the federal debate since these revenues are not collected at the federal level. It is not, however, lost on the home owner paying property taxes.

Average Effective Property Tax Rates per $1,000 of Value
2019



For 2021, total property tax collections by state and local governments summed to $1.86 trillion. NAHB estimates that one-third of these collections were due to housing for a total of $672.5 billion.[26] Data from the Census Bureau indicates that the average home owner pays property tax at an effective tax rate of 1.03% of the market value.[27]

<u>Limits on Property Tax Deduction Penalize Families and High-Cost Regions</u>

Prior to 2018, taxpayers not subject to the Alternative Minimum Tax[28] faced no limit on the amount of state and local taxes (SALT), including real estate taxes, that could be deducted from their federal taxes. Beginning in 2018, itemizing taxpayers are limited to a maximum $10,000 deduction for all state and local tax deductions. The $10,000 cap is set to expire after December 31, 2025.

Unfortunately, this cap has had negative effects on housing affordability in states with high housing costs. Although the cap is often correctly viewed through the lens of high-tax versus low-tax states, an interesting counter-factual is offered by comparing Alabama and Hawaii. Both states have exceptionally low real estate tax rates, with Alabama at 0.37% and Hawaii with the lowest rate of any state at 0.31%. But due to differences in home values, the average property tax bill in Alabama is $713, compared to $2,295 in Hawaii.[29]

Regional differences in housing costs present a challenge to crafting balanced housing policy. NAHB believes the current SALT limit fails to strike a balance between high-cost and low-cost regions. Worth noting is the $10,000 limit is identical for singles and couples, imposing a sizeable marriage penalty. As demonstrated earlier in this testimony, home size—and value—correlates with family size.

NAHB believes Congress must revisit the current limits on the SALT deduction. For high-cost as well as high-tax states, the $10,000 deduction limit effectively increases the ongoing costs of owning a home by denying home owners a full deduction of their property and other state and local taxes. Under the principle that taxes paid to state and local governments should not be taxed as income by the federal government, NAHB supports the elimination of the SALT deduction cap.

Home Equity Deduction

Prior to 2018, home owners we able to deduct interest allocable to up to $100,000 of home equity loan debt. This deduction was separate from the mortgage interest deduction. Under the Tax Cuts and Jobs Act, this separate deduction was temporarily eliminated. Under current law, the deduction is reinstated after December 31, 2025.

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[26] https://eyeonhousing.org/2022/07/property-taxes-make-up-more-than-one-third-of-state-and-local-tax-revenue/

[27] US Census Bureau's 2019 *American Community Survey 2019* and NAHB calculations.

[28] The state and local tax deduction is disallowed when calculating tax liability under the Alternative Minimum Tax.

[29] https://eyeonhousing.org/2021/10/property-taxes-by-state-2019/

Home equity loans are defined as mortgages that are either used for purchase, construction or improvement purposes or as a means to access equity. The type of use of the home equity loan is important in the rules for the Alternative Minimum Tax. In general, deductions for mortgage interest may be claimed against AMT taxable income. However, interest on home equity loans **not** used for home improvement purposes may not be claimed against AMT tax liability.

Home owners may continue to deduct home equity debt if it is used to substantially improve an eligible home and the total amount of mortgage and home equity debt does not exceed $750,000.[30] However, with inflationary pressures—building material prices are up 19% year over year—and the lowering of the MID acquisition debt cap, alongside a lack of inflation adjustment, is placing pressure on home owners seeking to improve their properties. Absent enactment of a credit to replace the MID, NAHB urges Congress to restore the separate $100,000 home equity deduction immediately, or otherwise increase the acquisition debt cap for the MID to better enable home owners to make substantial improvements to their home.

According to the 2009 American Housing Survey, half of all home equity loans are used for remodeling purposes. Remodeling is, of course, another form of housing investment which creates jobs and improves the nation's housing stock, particularly with respect to energy efficiency. Disallowing a deduction for interest for home remodeling provides a disincentive for home owners to improve the nation's existing housing stock and hurts job creation in the remodeling industry.

There is no data that indicates what the remaining half of home equity loans are used for, but anecdotal evidence suggests that those purposes include college expenses, health emergencies and some consumption purposes.

Remodeling and home improvement are important economic activities for a nation with an aging housing stock. A 2019 data analysis of remodeling expenditures by zip code aligns in many cases with areas of the country with older housing stock.[31] Remodeling also plays a key role as the home owners age. From survey data NAHB conducted in 2018, interest in remodeling to enable aging-in-place is growing and a growing share of remodelers are focusing on this market.[32] Remodeling also has positive economic effects. Every $100,000 in remodeling expenditures creates 0.89 full-time equivalent jobs and generates $42,383 in taxes according to NAHB estimates.[33]

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[30] https://www.irs.gov/newsroom/interest-on-home-equity-loans-often-still-deductible-under-new-law

[31] https://eyeonhousing.org/2019/05/just-released-nahb-remodeling-by-zip-code-estimates-for-2019/

[32] https://eyeonhousing.org/2019/05/remodeling-to-age-in-place-remains-strong-still-mostly-for-older-homeowners/

[33] https://www.nahb.org/news-and-economics/housing-economics/housings-economic-impact/impact-of-home-building-and-remodeling-on-the-us-economy

Capital Gains Exclusion

Brief History of the Capital Gains Exclusion

Prior to 1997, capital gain due to sale of a principal residence was governed by a complicated set of rollover and exclusion rules.

The *Revenue Act of 1951* allowed a taxpayer to "roll over" the capital gains received from the sale of a principal residence if, within one year, the taxpayer used the gain to acquire a new residence of equal or greater value. The rollover period was later extended to 18 months under the *Tax Reduction Act of 1975* and to 24 months in the *Economic Recovery Tax Act of 1981*. Thus, no capital gains taxes were generated until a home owner purchased a principal residence of smaller value than their previously owned residence or ceased to be an owner of a principal residence.

The *Revenue Act of 1964* introduced the first exclusion of capital gains arising from the sale of a principal residence. Under this law, taxpayers 65 years or older could exclude up to $20,000 in capital gains if they owned the house for at least eight years and lived in the home for at least five. The *Tax Reform Act of 1976* later increased this exclusion to $35,000.

The *Revenue Act of 1978* made a series of additional changes to the tax treatment of capital gains on the sale of principal residence. It lowered the minimum eligible age for the gains exclusion from 65 to 55 and increased the exclusion amount to $100,000. It also allowed a taxpayer to elect a one-time capital gains exclusion on the sale of a principal residence as long as the taxpayer lived in the home for three of the last five years. The *Economic Recovery Tax Act of 1981* increased the $100,000 exclusion to $125,000.

Simplification Arrives: The Changes of 1997

The Taxpayer Relief Act of 1997 vastly simplified the complicated rollover and gains exclusion rules by repealing them and starting over. In their place, Congress allowed a taxpayer to exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. The exclusion could be claimed no more than once every two years. To be eligible for the exclusion, a taxpayer must have owned the residence and occupied it as a principal residence for at least two of the five years prior to the sale or exchange.

These changes represented a significant improvement over what was, according to the Joint Committee on Taxation, "among the most complex tasks faced by a typical taxpayer."[34] As Joint Tax noted, despite the fact that most home owners never paid tax on the sale of their principal residence due to the previous rollover and exclusion roll rule, it was necessary to keep detailed records of both purchase and sales transactions, but also remodeling expenditures in order to accurately calculate the tax basis of their home. Adding complexity to this recordkeeping requirement was separating expenditures for repair and improvement that added basis to the home and those that did not. Finally, the deferral of gain based on purchasing a more

[34] General Explanation of Tax Legislation Enacted in 1997, Joint Committee on Taxation, December 17, 1997, JCS-23-97).

expensive home as a home owner moved through their lifecycle was also inefficient in that it may have deterred some home owners from moving from high-cost to low-cost areas.

Congress has adopted one subsequent change that was included in the *Housing and Economic Recovery Act of 2008* (HERA) to prevent speculators from abusing the capital gains exclusion. The 1997 reforms established the “two-of-five” test that defined a principal residence as one where a home owner had used the home as a primary residence for two years of the five-year window prior to sale. This created a scenario whereby an owner of a residence could hold the property for a long period of time, reside in it for two years, and then claim the gain exclusion.

While this taxpayer may have owned the residence, they were most likely using it as a rental property for the majority of the years of ownership. This “gaming” of the system was inconsistent with the spirit of the law, which had a focus on principal residence ownership.

NAHB supported the fix Congress passed to prevent a taxpayer from excluding the gain earned during periods of nonqualified use. The HERA change effectively shut down the ability of speculators to use the gain exclusion while protecting the 1997 enacted reduced recordkeeping and calculation requirements.

Impacts from Eliminating the Gains Exclusion

Removing or otherwise weakening the gain exclusion for the sale of a principal residence would have two strongly negative effects for existing home owners. First, it would lay a direct and unexpected tax bill on home owners who expected to use housing equity as a source of retirement wealth. Second, weakening the gain exclusion would reduce demand for housing by increasing the lifetime tax burden on principal residences. A reduction in demand would push housing prices down, thereby inflicting a windfall loss on existing home owners. Of course, since a significant share of home owner wealth is due to housing equity, eliminating the gains exclusion would have far reaching consequences.

It is also worthwhile to note the limitations on claiming a tax loss from the sale of a principal residence. In general, a loss incurred on the sale of a personal residence is a nondeductible personal loss for income tax purposes. This rule is different than losses for the sale or exchange of a financial investment for which the loss can be deducted against capital gains income.

Overall, it is also important to remember that there are various—and sometimes differing—tax benefits and burdens that are levied on investments, both housing and financial. Analysts debating federal tax policy often ignore the state and local government tax burden placed on housing via property tax. Such tax on property value differs from income tax in that the tax is levied on the value of the asset rather than a flow of net income. While housing receives some unique benefits in the tax code, like the capital gains exclusion, housing also faces a tax burden unlike other investments.

With a minimum two-year ownership period, the requirement that the home be used as a principal residence, and the closing of the second home loophole in 2008, the gains exclusion is targeted in a manner where real estate speculators or investors seeking a tax shelter will find no benefit. This is a tax benefit aimed exclusively at long-term owners of a principal residence. As a home is typically the largest source of household wealth, the home has become a retirement vehicle for many Americans. In some ways, the capital gains exclusion functions much like a Roth IRA, where the retirement gains are also completely excluded from the taxpayer's income.

While NAHB strongly supports retaining the gains exclusion, we also note this is another tax provision that is not indexed for inflation. Since the simplified gains exclusion was enacted in 1997, the lack of an inflation adjustment has eroded the value of this tax benefit significantly. In 2022 dollars, the original $250,000 limit would be equal to approximately $435,000.[35] Recent gains for home prices mean that a growing number of home owners may lose the tax simplification that this provision is intended to provide. Indeed, over the last decade, Case-Shiller home price data indicates a gain of 117% for home values. Accordingly, NAHB encourages Congress to index the gains exclusion to inflation moving forward.

Completed Contract Rules

Brief History of the Rules

Under current law, a long-term contract is defined as a building, installation, construction, or manufacturing contract that is not completed by the end of the taxable year in which it is entered.

Prior to the changes made in the *Tax Reform Act of 1986*, taxpayers could generally elect to account for income and expenses attributable to long-term contracts under the percentage of completion method or the completed contract method. Under the completed contract method, the gross contract price is included in income in the taxable year in which the contract is completed. Under the percentage of completion method, income is taxed according to the percentage of the contract completed during each taxable year.

Certain other limitations and rules applied, and there were additional rules for "extended period" long-term contracts—contracts not expected to be completed within 24 months. An exception to these "extended period" rules was provided for contracts for the construction of real property if the contract was expected to be completed within three years, or if the contractor's average gross receipts for the previous three years did not exceed $25 million.[36]

Changes in the *Tax Reform Act of 1986*

Congress believed that the completed contract method permitted an "unwarranted deferral of the income from those contracts."[37] Specifically, the Joint Committee on Taxation reported to Congress that certain large defense contractors had negative tax rates due to net operating loss carryforwards generated through use of the completed contract method. In response, the *Tax*

[35] Bureau of Labor Statistics CPI Inflation Calculator. $250,000 in January 1998 equates to $434,944 in January 2022. http://www.bls.gov/data/inflation_calculator.htm
[36] General Explanation of the Tax Reform Act of 1986, published by the Joint Committee On Taxation (JCS-10-87), pg. 524-526
[37] Ibid, pg 527

Reform Act of 1986 adopted a modified percentage of completion method that would apply to all long-term contracts.

The Act did include a modest exception for small construction contracts. Contracts for the construction or improvement of real property, if the contract is expected to be completed within two years, could be accounted for under the previous completed contract rules. However, the exemption was limited to taxpayers whose average gross receipts in the previous three tax years fell below $10 million.

Unintended Impacts on New Home Construction and the Home Construction Contract Exemption

Congress' intent in changing the completed contract rules was aimed largely at defense contractors who were deferring income taxes on projects that had a multi-year contract, such as during the lengthy construction period for an aircraft carrier. Defense contractors generally received substantial progress payments from the government and taxing these types of contracts under the percentage of completion method is appropriate. In enacting the *Tax Reform Act of 1986*, Congress also attempted to ensure that residential construction was largely unaffected by these changes, as seen by the inclusion of the exception for small construction contracts. At the time, home builders largely believed these changes did not impact them because their agreements with their customers were viewed as sales contracts, not construction contracts.

However, in 1988, the IRS released Advance Notice 88-66, which would have adversely affected the operations of home builders. NAHB realized at this time that the protections Congress included through the exemption for small construction contracts fell short. Prior to this notice, residential real estate developers took the position that the typical agreements of sale entered for the sale of a new home were not "construction contracts" subject to the accounting rules under Section 460.

Home sales agreements differed considerably from a typical construction contract, particularly when compared to the contracts of a defense contractor. A home sales agreement involves a developer agreeing to sell the home to the buyer in the future, with the developer retaining title to the property and bearing all economic risks until closing, with no progress payments, and typically only backed by a small deposit. Builders normally do not realize any profit until closing, which occurs after the home is constructed.

The IRS was proposing to tax home builders on income they had not yet received. Due to the length of home construction, it is common for a new home to straddle two tax years. Although home builders viewed these agreements as contracts of sale rather than as construction contracts as defined by Section 460, the IRS Advance Notice revealed that the government viewed these sales contracts as long-term construction contracts subject to the new accounting rules. This change would mean that home builders would need to significantly alter their business model.

Although buyers put down a deposit, the deposit is generally kept in an escrow account and cannot be used to cover construction costs or tax payments. Moreover, unlike with defense contracts, progress payments are not typical because most homes are financed by a mortgage at closing. If these homes were subjected to the new accounting rules, most builders are very small businesses, so they would be forced to finance the tax payments through a construction loan, which would increase the cost of home construction for the buyer.

The proposed changes would have caused significant cash-flow problems for home builders and imposed a larger barrier for smaller homebuilders who lack the financial means to cover the tax payments. In response, Congress included relief in the conference report for the *Technical and Miscellaneous Revenue Act of 1988* by clarifying in Section 460(e) that "home construction contracts" were not subject to the percentage of completion accounting methods. The conference report describes a home construction contract as one where "80 percent or more of the estimated total costs to be incurred under the contract are reasonably expected to be attributable to the building, construction, reconstruction, or rehabilitation of, or improvements to real property directly related to and located on the site of, dwelling units in a building with four or fewer dwelling units."[38]

NAHB believes that Section 460(e) is consistent with both Congress' intent in 1986 to shield the residential construction industry but also with the unique contractual agreements used for home construction. This is a case where a broad definition of "construction" resulted in unintended consequences that were potentially harmful to home builders and buyers alike. NAHB believes that it did not make sense to apply an accounting method to home builders that was really targeted to address other tax problems, and that same rationale continues to support maintaining Section 460(e).

Multifamily Rental Tax Policies

The LIHTC is a Success Story, but Need Exceeds Resources

The Low-Income Housing Tax Credit (LIHTC) was created during the Reagan Administration as part of the Tax Reform Act of 1986 as a more effective mechanism to produce affordable rental housing. It is the most successful affordable rental housing production program in U.S. history. Since its inception, the LIHTC has produced and financed more than 3.5 million affordable apartments. As LIHTC properties must generally remain affordable for 30 years or longer, they provide long-term rent stability for low-income households around the country. But the demand for affordable housing is acute and exceeds the availability of financing through the LIHTC program.

The LIHTC is a unique private-public partnership. The benefits of this structure are evident in the quality of the projects. Its public-private partnership model is one that frankly should be replicated in other government programs. When a builder starts a LIHTC project, the investors and builder assume all the risk. If the project fails, the taxpayer is protected, as the IRS can and will reclaim the tax credits. Since the investors cannot claim the credits until after the project is placed in service, it is the rare public program where the taxpayer gets what they are paying for, or the taxpayer does not pay.

[38] H.R. Conf. Rep. No. 100-1104, pg 118

A key component to the LIHTC's success is the flexibility the state agencies have to target specific types of affordable housing developments. For example, a state with a large population of seniors may offer a developer bonus points on an application for focusing on senior housing. Other targeted projects include assisted living; family housing; homeless; and housing for the disabled. This flexibility allows each state to determine what types of affordable housing are best suited to the demographics of their state, rather than applying a single, national standard. Ultimately, however, a lot of needs are not being met as demand simply outstrips the availability of credits.

According to the National Council of State Housing Agencies (NCSHA), state housing finance agencies generally receive more than $2.5 in requests for every $1 in LIHTCs available. In 2020, state agencies received applications for $2,782,533,692 in credits. Total allocations were $1,120,921,542.

But this does not tell the whole story. The application process is expensive, and experienced developers will not submit applications for viable projects when there are inadequate resources to support it. So there is a shadow demand for credits not reflected in the above data.

Nationally, demand varies somewhat from year to year but generally remains high. It is useful to compare the 2020 national numbers against 2008. 2008 was the height of the financial crisis, and multifamily development was at a low point. Many traditional LIHTC project investors were not investing, which made putting together deals much more challenging. Nationally, there were applications for $1,873,311,018 in credits. Credits allocated were $939,924,853.[39] Even in one of the most challenging times for real estate development, demand was still double the amount of available credits. We can see over several years and in different economic environments, demand for tax credits remained steady at double or more of the available credits.

LIHTC development remains stable because the need for affordable housing is significant. Consistent demand for credits also reflects the advantage of creating this credit in the tax code. Investors have confidence in the predictability of the tax code, which allows LIHTC developments to continue even during economic downturns. The LIHTC enables a fairly constant supply of affordable housing, as well as a financing mechanism that ensures long-term operation of affordable housing. In fact, LIHTC tax credit projects outperform the rest of the multifamily housing sector in one key measure: the annualized foreclosure rate. This rate is less than one tenth of a percent[40] and a third of the rate for other multifamily properties. The success of these projects partially reflects the ever-present threat that the government can recapture tax credits if the project fails.

To start meeting the growing and significant demand for affordable rental housing, we must increase resources supporting production, which is why we support the Affordable Housing Credit Improvement Act (H.R. 2573). Among other key provisions, H.R. 2573 takes a

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[39] State HFA Factbook: 2008 NCSHA Annual Survey Results, pg 92

[40] "The Low Income Housing Tax Credit: Assessment of Program Performance & Comparison to Other Federal Affordable Rental Housing Subsidies," by Novogradac & Company, LLP, 2011, Page 4 http://www.novoco.com/products/special_reports/Novogradac_HAG_study_2011.pdf

significant and needed step to boost supply by increasing LIHTC allocations by 50 percent. Estimates suggest enacting H.R. 2573 would result in up to 2,015,000 additional LIHTC units.[41]

Failure to take action now will only deepen the crisis. Rental housing demand remains solid, and more housing is needed to help address growing affordability challenges. Absent new supply, this demand will increase rents and worsen existing affordability issues.

Net Investment Income Tax—Adding Taxes to Rising Rents

The Net Investment Income Tax (NIIT) is a 3.8% surtax on income such as capital gains, interest, rental and royalty income, and dividends. When the NIIT was enacted as part of the Affordable Care Act, Congress explicitly limited its applicability to passive investment income.

Proposals in Build Back Better, and recently reported to be under consideration in the Senate, would expand the NIIT to include active investment income. This would have negative consequences, particularly for renters.

Multifamily property owners are facing the same financial stresses as any home owner. Operating costs are rising. Higher interest rates increase development and rehabilitation costs. Rising real estate values often translate into higher tax appraisals resulting in higher property tax bills. Some multifamily property owners are reporting significant increases in insurance rates as insurers adjust to reflect the increased cost of construction, should there be a major event requiring reconstruction. Along with ongoing demand for rental housing, these inflationary pressures are translating into higher rents.

Expanding the NIIT to include active investments has the same financial effect on property owners as increasing operating costs. If Congress moves forward with this proposal, property owners will have no choice by to pass on some, if not all, of the additional tax burden to their tenants.

With home prices and rents rising even faster than inflation, rising interest rates, and a growing scarcity of both entry-level owner-occupied housing as well as affordable rental units, Americans are being squeezed hard. Rent inflation increased in June at the fastest pace since 1986.

To solve our housing affordability crisis, Congress should be removing barriers, not enacting new ones. NAHB strongly recommends against expanding the NIIT to include active investment income.

Carried Interest

The taxation of a capital gain due to a carried interest is an important issue for the real estate industry and particularly for the multifamily housing sector, both market-rate rental and Low-Income Housing Tax Credit. Under present law, a capital gain classified as a carried interest is taxed like any other capital gain. Carried interest has come under attack for how it is used by the

[41] https://static1.squarespace.com/static/566ee654bfe8736211c559eb/t/607763314b628a205aa010a4/1618436913622/ACTION-NATIONAL-2021.pdf

hedge fund industry, but broad attacks on carried interest ignore the key role it plays in real estate development.

The use of partnerships and other pass-thru entities is common in the home building industry and the construction sector generally. In a common arrangement, a builder/developer performs the role of the general partner and outside investors act as limited partners, who provide much of the initial equity financing. Typically, the general partner receives a developer's fee (and possibly subsequent fees for owning and operating the property) and the limited partners receive a specified rate of return on their investment. Any residual profits are split between the multifamily builder/developer/property owner and the investors as defined by the partnership agreement. Of course, the particulars differ depending on the nature of the project, the types of developers, and the role of outside investors.

In many cases, the developer's share of the residual profit, if it is realized (uncertain at the time of the deal), is classified as a "carried interest," which is an allocation of profit that as a share of total profit exceeds the share of the developer's initial equity investment in the project.[42] The carry can be ordinary income or capital gain, but the current policy debate is limited to a carried interest that is due to a capital gain at the partnership level. Carried interest that is paid as ordinary income is unaffected by the proposals being debated in Congress. Capital gain typically arises in such arrangements through the sale of a tangible, depreciable asset that is held for more than one year. For example, this situation would include a building that was constructed, owned and operated for a period of time and then sold to other investors.

Table 1 illustrates this in more detail for a hypothetical partnership with $100 million in initial equity financing ($95 million from outside interests, and $5 million from the home builder), a 10% preferred return for the limited partners, and a 50%-50% division of residual profit. Under this example, the multifamily developer's capital gain income is a carried interest (portion in excess of 5% - the initial equity stake) and would be subject to additional tax under existing proposals.

[42] Note that technically this definition describes both promoted and carried interests. A "promote" is often used to refer to any share of profit allocation greater than the initial equity stake, and a "carry" is a type of promote for which there is little or no equity stake. However, in the current debate, the term "carried interest" now captures all of these scenarios.

Table 1: Illustration of Partnership Income Distributions and Tax Consequences

	Partnership Level	Home Builder: General Partner	Share	Outside Finance: Limited Partners	Share
Equity Invested	$100.00	$5.00	5.00%	$95.00	95.00%
Capital Gains Income: First Distribution	$9.50	$0.00	0.00%	$9.50	100.00%
Residual Capital Gains	$10.50	$5.25	50.00%	$5.25	50.00%
Total Return	$20.00	$5.25	26.25%	$14.75	73.75%
Carried Interest Test under H.R. 4213		26.25% > 5%		73.75% > 95%	
Carried Interest		Yes		No	
Tax Rate under Present Law		15%		15%	
Taxes Paid under Present Law		$0.7875		$2.2125	
Tax Rate under Proposal		35%		15%	
Taxes Paid under Proposal		$1.6375		$2.2125	
Difference in Taxes Paid		$0.8500		$0.0000	

Assumptions:
Dollar amounts in millions
Project yields 20% return over time period
All income is capital gains at partnership level
LPs receive first 10% return
Residual gains beyond first 10% are split 50% each to GP and LPs
Partners face ordinary income tax rate of 35%

Putting aside the tax issues, the carried interest in the above multifamily development example serves two important economic purposes. First, it provides an incentive for the multifamily developer and property owner to control costs and operate the property efficiently in order to generate a profit for the outside investors. This incentive makes the investment more attractive for investors, helping to attract investment for multifamily projects, particularly those in higher risk environments, such as economically distressed areas.

Second, the carried interest transfers business risks associated with the development project to the multifamily builder and owner, who may be more familiar with market conditions and in better position to manage the risks. These risks include changes in administrative expenses, local regulations, and of course local market conditions. Further, a multifamily developer may assume additional risk by making additional guarantees to the outside investors. For example, the developer can guarantee the completion of the project, or the servicing of debt used to finance the project. Carried interest allows multifamily builders to be compensated for making these guarantees and assuming the risks. Hence, partnerships with carried interest mechanisms are excellent financial arrangements for allowing multifamily developers and outside investors to share business risks efficiently.

Increasing the tax on carried interest for the real estate sector also results in a transfer of tax revenue from state and local governments to the federal government by reducing the value of multifamily investments, thereby lowering property tax collections at the local level.[43] Based on proposals considered by Congress in 2010 which would tax carried interest as ordinary income, NAHB estimated that the total amount of property taxes lost to state and local governments for the real estate sector would be approximately $1.2 billion per year.[44] Given that the federal revenue estimate for the carried interest proposal, at that time, was $24.6 billion, this $12 billion

[43] For more detail on how NAHB calculated the impacts, see: http://www.nahb.org/generic.aspx?sectionID=1081&genericContentID=131457#top2

[44] NAHB's analysis was based on H.R. 4213 in the 111th Congress

ten-year estimate demonstrates that the proposal generates a significant transfer of tax revenues from state and local governments to the federal government.

NAHB supports the current carried interest tax rules as they apply to commercial and residential real estate. Should Congress decide to make changes to current law, it is absolutely essential that the transitional rules include a grandfathering provision for current contracts. As many multifamily projects are held for years before a gain is realized, a sudden shift in tax policy will have a significant and negative impact on real estate.

Depreciation

Rental property can be depreciated on an accelerated timeframe over a period of 27.5 years, versus a 39-year depreciation schedule for commercial real estate. In addition, individual components can be depreciated under various, shorter timeframes through the use of cost segregation rules.

Maintaining a reasonable depreciation period for rental housing is critical. If the period is too long, it will increase costs and make it harder to develop rental housing. Changes to the depreciation schedule will impact the financial viability of existing multifamily buildings, which could result in foreclosures and price declines. Depreciation is also a key to attracting outside investors.

For these reasons, NAHB opposes changes to the depreciation rules that would extend the depreciation period of property associated with residential rental property. It is also worth noting that while Congress has enacted and continues to debate the value of various expensing proposals (e.g., bonus depreciation), such rules typically exclude structures such as apartment buildings (property with more than 20 years of economic life).

Conclusion

NAHB is an organization that represents all facets of the residential construction industry, including for-sale builders of housing, multifamily developers, remodelers, manufacturers, and other associate members. As such, NAHB defends housing choice. While homeownership offers communities and households numerous benefits, it is important to recognize that for every family there is a time to rent and a time to own a home.

For these reasons, NAHB also supports policies that promote a healthy rental housing sector, including support for the Low-Income Housing Tax Credit, which was created as part of the *Tax Reform Act of 1986* and has become a successful public-private partnership that assists in the development of affordable housing.

NAHB also recognizes there are policies that need to be modernized to reflect changes in the tax code, including the mortgage interest deduction. In the next few years, many of the provisions enacted in the *Tax Cuts and Jobs Act* will expire. This presents an opportunity to refocus the homeownership tax incentives so that the benefit flows to lower and middle-class families, making homeownership more accessible.

And as owning a home is a significant means for savings for most home owners, the capital gains exclusion protects that investment, but the value of this provisions is eroding due to inflation. We encourage Congress to remedy this.

Without meaningful homeownership tax incentives, NAHB believes that disparity in economic income will increase, and the middle class would continue to shrink. Homeownership is the major path to wealth for the middle class. We believe that any policy change that makes it harder to buy a home—or delays the purchase of the home until an older age—will have significant long-term impacts on household wealth accumulation and the makeup of the middle class as a whole.

With home prices and rents rising even faster than inflation, and a growing scarcity of entry-level owner-occupied housing along with affordable rental units, and rising interest rates, Americans are being squeezed hard. National home prices are growing at an unsustainable pace, reaching an all-time high seasonally adjusted annual growth rate of 28.2%.[45] Forty percent of core inflation is driven by shelter costs.[46] More cost increases are coming for this category, which will add to inflationary forces in the months ahead. And prospective home buyers are not only facing higher home prices, but also higher carrying costs due to increases in interest rates. Building material prices collectively are up 19.2% year-over-year and 35.6% since the start of the pandemic.[47] It comes as no surprise that the median price of a newly built, single-family home increased 19.7% year-over-year. This country was already facing a housing affordability crisis, but the inflationary effects of the building material price increases are squeezing home buyers even more. A year ago, 23% of new home sales were priced below $300,000. In May, it was only 10%.[48]

Rising home prices and interest rates are taking a terrible toll on housing affordability, with 87.5 million households — or roughly 69% of all U.S. households — unable to afford a new median-priced home.[49] In other words, seven out of 10 households lack the income to qualify for a mortgage under standard underwriting criteria. We have now seen housing affordability fall to a decade low.[50]

While the Federal Reserve is attempting to quell inflation and achieve a soft landing, history suggests that based on current rates of inflation and labor market tightness, the probability of avoiding a recession is small. NAHB is now forecasting a mild recession for the coming quarters given current macro conditions. An argument can be made that a recession took hold during the first half of 2020 (due to two consecutive quarters of GDP decline), led by significant weakening including seven straight months of decline for home builder sentiment, as measured

[45] https://eyeonhousing.org/2022/05/home-prices-surged-in-march/
[46] https://eyeonhousing.org/2022/06/inflation-hits-a-fresh-40-year-high-in-may/
[47] https://www.nahb.org/blog/2022/05/building-materials-up-more-than-19-percent-year-over-year
[48] https://eyeonhousing.org/2022/06/new-home-sales-increase-in-may-before-feds-june-rate-rise/
[49] https://www.nahb.org/News-and-Economics/Housing-Economics/Housings-Economic-Impact/Households-Priced-Out-by-Higher-House-Prices-and-Interest-Rates
[50] https://www.nahb.org/news-and-economics/press-releases/2022/05/new-home-sales-down-on-rising-interest-rates-declining-affordability

by the NAHB/Wells Fargo Housing Market Index (HMI). In July, the HMI fell 12 points to 55, which marks the lowest HMI reading since June 2020 and the largest single-month drop in the history of the HMI, except for the 42-point drop in April 2020.[51]

NAHB greatly appreciates the overwhelming bipartisan Senate support to solve our affordable housing crisis. In this era of increasingly partisan political discord, I hope we can all unite around this issue and take action. Shelter is a basic human need and a leading source of inflation. Through smart, effective policy, we have an opportunity to do something that not only makes good economic sense but will also uplift the lives of millions of Americans.

[51] https://eyeonhousing.org/2022/07/builder-confidence-plunges-as-affordability-woes-mount/