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Dividend Exclusion Proposal Threatens Future of Tax Credit Investment

By Alex Ruiz, Staff Writer, Novogradac & Company LLP

President George W. Bush's plan to exclude certain corporate dividend payments from federal income taxes received a warm welcome on Wall Street, but its potential impact on the low-income housing tax credit (LIHTC) and other programs has raised significant concern among the affordable housing and community development investment industries. (See related stories on page eight and page 24.)

"As structured, the proposal could have a significant negative effect on affordable housing and community development investments. Consequences could be felt by the LIHTC, new markets tax credit (NMTC), historic tax credits and tax-exempt housing bonds if corporations cease to retain earnings they invest in these programs and are incentivized to distribute earnings," says Michael J. Novogradac, Novogradac & Company LLP managing partner.

In a statement last month, the Treasury Department alleges that the double taxation of corporate profits "creates severe economic distortions … and incentives for corporations to engage in transactions for the sole purpose of minimizing their tax liability." The administration argues that by excluding dividends, this incentive would be diminished, but industry professionals contend that the consequences would be more widespread. "While the intention may be to reduce the incentive for tax shelters, as written, the proposal may inadvertently dramatically lessen the incentive to invest in affordable housing and community development subsidies that rely on the ability to off-set federal tax liability to attract corporate investors," Novogradac says.

"Such a result is clearly nonsensical when applied to the LIHTC, because it was created specifically to generate equity for affordable housing production," says David Smith, Recapitalization Advisors vice president. "The administration cannot have intended to cripple LIHTC markets, introduce massive uncertainty and anxiety, or collapse the equity value of a principal federal resource that is efficient, effective and universally popular."

In the meantime, Smith predicts that just the plan's announcement will have an immediate impact. "This would destabilize, not to say collapse, prices of LIHTC investments," Smith says. "Even the possibility of its enactment will likely freeze LIHTC activity."

David Gasson, vice president for public affairs at Boston Capital Corp., says that the doubt Bush's proposal has introduced may well be worse than the eventual effects themselves. "Uncertainty is the death knell of this industry," he says. "That is why we need to nip this in the bud as soon as we can. Some corporations are already talking about sitting on the sidelines instead of waiting to see how it turns out."

Concerns for Other Tax Credits, Tax-Exempt Housing Bonds

In addition to the LIHTC, the fallout could affect several other similar or related programs. The New Markets Tax Credit Coalition (NMTCC) predicted last month that the proposal could stunt the potential of the fledgling new markets tax credit (NMTC) program. The coalition acknowledged it may have a different or greater impact on LIHTCs, but warned members "the proposal introduces a new level of uncertainty into the program and may, at minimum, complicate investor decision-making."

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Additionally, the proposed single-family homeownership tax credit, a Bush campaign pledge and the centerpiece of his administration's housing policy, could be rendered void under this plan.

The *Chicago Sun-Times* reported last month that municipal bond prices fell slightly in the days following the proposal's announcement because of concerns they'd lose their appeal to investors. Furthermore, a report issued last month by California treasurer Phil Angelides says the White House plan will cost U.S. taxpayers as much as $155 billion in higher interest payments on municipal bonds over the next 10 years. Angelides says the higher costs stemming from the Bush administration proposal would also make it difficult for local governments to issue bonds to finance critical public investments. "The Bush plan would completely change the playing field of investing in America," Angelides says. "There is no question this new arena will drive up interest rates on municipal bonds."

In a report last month, Standard & Poor's questioned the impact of Bush's stimulus plan on bond yields. "Not only would the exclusion of dividend payment have revenue implications for state governments, which compute income tax payments based upon federal income calculations, but it would also make stocks more attractive to the traditional municipal bond investor," S&P says. "Any competition for investors would inevitably increase bond yields and concomitant state debt service expenses. Whether investors actually accept tax-exempt dividends as a substitute for traditional tax-exempt bonds is a key question, as municipal bonds have historically been differentiated in terms of the security and reliability that they provide to investors."

What Happens Next?

Smith says if the administration recognizes there will be circumstances where a tax credit should have its equity value protected—as it did by exempting foreign tax credits from the plan—then the LIHTC, NMTC and homeownership credits are certainly worthy of the same consideration.. "That it was an oversight is understandable – but it must be reversed, and quickly, lest the administration's proposal do significant and enduring damage," says Smith.

Gasson agrees that the best remedy would be to 'carve out' the LIHTC and other related credits, giving them the same exemption from the proposal as foreign tax credits. The LIHTC industry is in a strong position for two reasons, he says. First, because of how it benefits the corporations that invest in the credits. Additionally, because it is a permanent part of the tax code with a congressional mandate—that it has fulfilled—the LIHTC does not deserve to be lumped in the same category as corporate tax shelters.

Both Smith and Gasson have seen a substantial response from industry leaders and concerned constituents, but Smith takes a more urgent position on pushing for a remedy. "Ordinarily, I would be confident in a normal six- to eight-

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Publisher
Michael J. Novogradac

Editor
Jane Bowar Zastrow

Staff Writer
Alex Ruiz

Technical Editor
Robert S. Thesman

Contributor
James R. Kroger

Production
Alexandra Louie

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LIHTC Information

Address all correspondence and editorial submissions to:
Jane Bowar Zastrow
LIHTC Monthly Report
Novogradac & Company LLP
246 First Street, 5th Floor
San Francisco, CA 94105
Telephone: 415.356.8034
E-mail: cpas@novoco.com

Visit us on the web:
www.taxcredithousing.com

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month cycle," he says. "But this tax legislation may have significant momentum and could be passed in the next 90 days."

Gasson suggests the opposite might also be true: "You never know, this whole proposal could die of its own weight," he says. Gasson advises industry participants to be vocal, but rational. "The (congressional) staffs are grateful for a rational approach; don't say 'We're dead,' or 'The sky is falling,' they hear that all the time," he says. "Instead, show them what will happen, give them models. Like everyone else, the staffs are just now learning about this. We, from the LIHTC industry, were the first ones from any industry to talk to them about possible negative effects, and this is going to affect a lot of other, more influential, industries," he says.

In meetings with congressional staff members late last month, Gasson says he received encouraging response from Democrats and Republicans alike. Likewise, he notes, the chairmen and senior members of the various congressional tax writing committees rather than openly voicing their support, have been relatively quiet following the release of the president's proposal Moreover Rep. Charles Rangel (D-N.Y.), the ranking Democrat on the Ways and Means Committee in a letter last month to Department of Housing and Urban Development (HUD) secretary Mel Martinez, warns that the president's stimulus package is "unfair and reckless" and could have a "catastrophic impact" on the LIHTC program.

"Corporations that had purchased low-income housing credits in the past will find that they paid full value for something that is now virtually worthless," the letter says. To remedy the conflict, Rangel requests Martinez' "urgent assistance in changing the proposal or clarifying its impact so that the low-income housing tax credit program can maintain its record of effectiveness." ❖

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