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Important Steps in the Trek Toward Tax Reform

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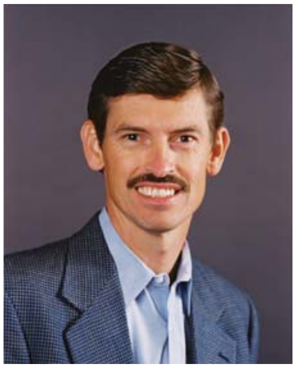

It's widely accepted that tax reform won't happen in the next few months, or even this year. But the affordable housing, community development, historic preservation and renewable energy communities should pay attention to the discussions that are taking place now because each step down the path toward tax reform has the potential to affect the outcome in the long term.

The march toward tax reform began more than a year ago. In January 2011, House Ways and Means Committee Chairman Dave Camp, R-Mich., began a series of hearings on federal income tax reform aimed at re-examining the tax code to determine the specific ways in which the current structure of the federal income tax discourages job creation and economic growth. In announcing the first hearing, Camp said it marked the beginning of a dialogue that President Obama and the Congress must have about broad-based tax reform. True to his word, Camp held hearings on tax reform throughout last year and he continues again this year. Likewise, Senate Finance Committee Chairman Max Baucus, D-Mont., has held more than a dozen hearings on tax reform in the past year and a half. The Senate committee has considered tax reform through a variety of lenses – incentives for innovation, incentives for homeownership, promoting retirement security, treatment of financial products, long-term solutions for tax extenders, and so on.

In May 2011, Treasury Secretary Tim Geithner affirmed the president's commitment to pursuing corporate tax reform. Initial reports suggested that the Treasury Department would release its plan last summer, but as readers now know, raising the national debt limit took center stage and dominated the administration's focus for most of the rest of the year.

Meanwhile on October 26, 2011, Camp unveiled his own tax reform discussion draft that proposed lowering top tax rates for both individuals and corporations to 25 percent. Camp would accomplish this rate reduction by broadening the tax base, which essentially is done by cutting or eliminating tax deductions and tax credits as well as income exclusions. Specific base broadening measures were not included in the October 26 discussion draft. While many in the business community expressed strong support for a top tax rate of 25 percent, some tax policy experts estimated that all corporate tax expenditures would have to be repealed in order to finance a rate at that level, potentially including the elimination of the low-income housing tax credit (LIHTC), new markets tax credit (NMTC), historic tax credit (HTC) and renewable energy tax credits (RETC). Scrutiny of Camp's proposal was overshadowed to a certain extent by the activities of the Joint Select Committee on Deficit Reduction, or Supercommittee, quickly followed by the battles over the extension of the payroll tax holiday.

Fast-forward to February 2012, when the White House and the U.S. Department of the Treasury released the president's framework for business tax reform. The document outlines President Obama's five recommendations for business tax

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reform:

1. eliminate certain tax expenditures and reform the business tax base;
2. refocus the manufacturing deduction and reduce the effective rate on manufacturing, while encouraging research and development and clean energy production;
3. introduce a minimum tax on foreign earnings;
4. make tax filing simpler for small businesses and entrepreneurs; and
5. either eliminate or make permanent and fully pay for temporary tax provisions now in the tax code.

The plan calls for a 28 percent corporate tax rate and an effective 25 percent rate for manufacturing. The framework also says the president would eliminate dozens of business tax loopholes and tax expenditures, but few specifics were included. The framework does not specifically mention LIHTCs, NMTCs or HTCs. But, RETCs are addressed in the section on extending, consolidating and enhancing clean energy incentives. Specifically, the president would make the tax credit for the production of renewable energy permanent and refundable.

Geithner indicated the proposal was designed to start the process of fundamental tax reform. "This process will take time. It will be politically contentious," he said. "Some will say these proposals are too tough on business, and others will say that they're not tough enough. Many will fight to preserve specific tax preferences and subsidies, but every preference Congress preserves for some requires the rest of America's businesses to pay a higher rate."

Presidential rivals have also released proposals for tax reform. Mitt Romney in February released an updated tax plan that calls for a 20 percent across-the-board cut to individual tax rates and a reduction in the top corporate tax rate from 35 percent to 28 percent. Other presidential hopefuls have proposed more dramatic reductions. Newt Gingrich suggested an optional 15 percent flat tax for individuals. Rick Santorum proposed collapsing the current six tax brackets into two, and setting a 17.5 percent corporate tax rate with no taxes on manufacturers. Ron Paul has recommended eliminating the income tax completely and reducing the corporate tax rate to 15 percent.

Because of the presidential election, most lawmakers have conceded that significant progress to reform the tax code won't happen until 2013, at the earliest. If history is any indication, it could be even longer; the Tax Reform Act of 1986 was passed more than four years after its first precursor bill was introduced. Nevertheless, the steps that are being taken now could be consequential.

What Tax Reform Could Mean for Tax Credits

With an endeavor as substantial as comprehensive tax reform,

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ideas that gain momentum or support can be swept up early and carried along in the process; those ideas can be overshadowed by debate over more controversial provisions, and as a result proceed without extensive discussion.

As such, constant vigilance will be needed to defend and support valuable tax provisions from being mislabeled and misunderstood. Accurately portraying the benefits and beneficiaries of the tax credits and refuting inaccurate or misleading statements about tax expenditures will be equally important.

Unfortunately, misinformation abounds about tax credits and tax expenditures. First, tax credits like the LIHTC, NMTC, HTC and others are often lumped in with all federal tax expenditures claimed by corporations, as if all federal tax expenditures were alike. In discussions about broadening the base, it will be crucial for the affordable housing, community development, historic preservation and renewable energy communities to make clear the philosophical difference between tax expenditures that create direct social impacts and those that create spillover social impacts. The LIHTC creates more affordable housing. The NMTC spurs community renewal in struggling neighborhoods. The HTC restores abandoned buildings to usefulness and preserves our nation's history. Energy tax credits have helped create tens of thousands of jobs.

Second, it is critical to communicate clearly that unlike tax loopholes, which provide unintentional benefits and are used to game the system, tax expenditures such as the LIHTC or NMTC were intentionally passed by Congress to further certain policy goals, such as creating affordable housing or spurring community development in blighted areas. This distinction is why these programs are also called tax incentives. Because they help achieve goals set by Congress, they are not loopholes, and they should not be condemned as such.

Moreover, any discussions about reducing or eliminating a tax expenditure should focus on the social welfare benefits versus the government costs of that particular expenditure. In November 2011, House Ways and Means Ranking Member Sander Levin, D-Mich., released a Joint Committee on Taxation (JCT) analysis that found that repeal of "almost all of the major corporate tax expenditures," on a revenue neutral basis, would result in the top corporate tax rate falling to approximately 28 percent. According to JCT analysis, repeal of the LIHTC would save only $4.8 billion over five years; this represents less than 1 percent of total tax savings.

Another significant distinction is that the LIHTC is a purchased tax benefit, and substantially all of the net economic benefit of the LIHTC goes to low-income families, not corporations. Re-

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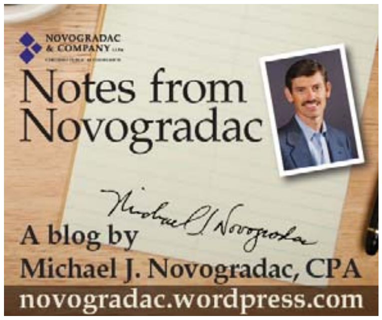
peal of the LIHTC would have only a modest economic impact on corporations, but would have a dramatic impact on low-income families. I discuss this point and related matters in more detail in my blog at novogradac.wordpress.com.



What's Next

The tax writing committees could begin drafting legislative language as soon as early 2013. In the meantime, lawmakers will continue to flesh out their plans and stake out more detailed positions on tax reform. The tax credit community should make it a point to be actively involved in the process in the coming months and years to ensure that reform efforts strengthen the tax code without undermining the positive contributions that the LIHTC, NMTC, HTC and RETC provide.

An Announcement from the Publisher

I am pleased to announce that this month Novogradac & Company will begin publishing the Journal of Tax Credits for the iPad. To find the app, simply go to the App Store and search for the Novogradac Journal of Tax Credits, or browse for us in the Newsstand category.

The app will allow you to buy and read the latest issue of the magazine or purchase an annual subscription. The iPad edition will give readers access to all the content from the Journal of Tax Credits print edition as well as bonus content, such as extra photos and other multimedia.

If you have questions about the iPad app, please send an email to CPAs@novoco.com.

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