Bush Dividends Exclusion Proposal: Potential Adverse Effects on Real Estate Tax Credits

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As structured, the Bush administration's proposal to exclude corporate dividends from taxation could have a significant negative effect on affordable housing and community development investments. Consequences could be felt by the low-income housing tax credit (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 forced to distribute earnings.

Under current law, corporate earnings may be subject to two levels of tax: one at the corporate level and one at the shareholder level. Income earned by a corporation is taxed at the corporate level, generally at the rate of 35 percent. If the corporation distributes earnings to shareholders in the form of dividends, then the income generally is taxed again at the shareholder level at federal income tax rates as high as 38.6 percent. If a corporation retains earnings, then the value of corporate stock generally will increase to reflect the retained earnings. When shareholders sell their stock, that additional value will be taxed in the form of capital gains (at a maximum federal rate of 20 percent). The Treasury Department estimates the resulting rate of tax on corporate income to be as high as 60 percent.

Under the administration's proposal, dividends paid by corporations to individual shareholders would be excluded from taxable income when paid out of previously taxed corporate income. Reducing taxable income would reduce the amount of dividends that could be passed tax-free; any excess would generally be taxable to the recipient shareholder. In this scenario, if a corporation with taxable income bought LIHTCs to reduce its taxes, the tax savings would be treated as sheltering an income-equivalent. The amount of income imputed from the tax credit would be considered as "un-taxed" at the corporate level and therefore taxable at the shareholder level. Thus, $350,000 of credits would be treated as having 'sheltered' $1 million [$350,000 / 35 percent corporate bracket] in income. The dividend piece that would otherwise be tax-exempt (in this example, $650,000 representing the $1 million minus the $350,000 of tax) would instead be made taxable to the shareholders because the LIHTC investment had been made. In effect, this would negate the benefit of LIHTCs; instead of $1 of LIHTC being worth $1, it would be worth much less.

The administration alleges that the double taxation of corporate earnings "creates severe economic distortions," such as "incentives for corporations to engage in transactions for the sole purpose of minimizing their tax liability." While the intention may be to reduce the incentive for tax shelters, as written, the proposal may inadvertently eliminate 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.

The LIHTC was created specifically to generate equity for affordable housing production and is virtually the sole federal production resource for affordable multifamily housing. It figures in an estimated 75 percent or more of all new affordable housing production nationwide, approximately 75,000-110,000 apartments a year. As such, the effect of the administration's proposal on this program, and in turn on the nation's supply of affordable housing, is potentially devastating.

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