NCSHA

February 25, 2003

The Honorable John W. Snow
Secretary
United States Department of the Treasury
1500 Pennsylvania Avenue, NW
Suite 3330
Washington, DC 20220

Dear Secretary Snow:

The National Council of State Housing Agencies (NCSHA), on behalf of the state Low Income Housing Tax Credit (Housing Credit) allocators, is pleased to share with you, "The Impact of the Dividend Exclusion Proposal on the Production of Affordable Housing," a February 2003 report prepared by Ernst & Young LLP at NCSHA's request. This report objectively documents the unintended adverse impact the Administration's proposed dividend tax exclusion would have on the production of affordable rental housing in America.

Neither NCSHA nor Ernst & Young has a position on the dividend proposal itself. NCSHA offers the Administration and the Congress this report to help build understanding of the implications of the proposal for affordable housing and, specifically, the Housing Credit. We hope the report will also be useful to you in assessing the dividend proposal's impact on other important housing and community revitalization tools, such as the Administration's proposed Homeownership Credit, the New Markets Tax Credit, and the Historic Preservation Tax Credit.

Ernst & Young estimates that 35 percent fewer Housing Credit apartments—40,000 fewer apartments serving about 100,000 residents—would be produced annually if the dividend exclusion proposal were enacted as proposed. Its analysis shows that corporate Housing Credit investors—which account for 98 percent of Housing Credit equity raised annually—would limit the amount of capital they invest in Housing Credits or lower the price they are willing to pay for them, reducing the amount of Housing Credit equity available to produce affordable rental housing.

NCSHA believes the total impact may be even greater. Ernst & Young does not take into account, for example, the impact of higher interest rates on tax-exempt housing bonds almost certain to result from enactment of the dividend proposal. Forty-two percent of Housing Credit apartments developed annually are financed with tax-exempt bonds.

America cannot afford the loss of a single affordable apartment, let alone 40,000 Housing Credit apartments annually. As of 2001, over seven million American renter families—one in five—suffer severe housing affordability problems. They spend more than half of their income on rent or live in substandard housing. Meanwhile, more than 150,000 apartments are lost to the low-cost rental housing inventory each year due to rent increases, abandonment, and deterioration.

In the face of this enormous need, the Housing Credit is the only significant producer of affordable rental housing. The Housing Credit is a federal tax incentive Congress has empowered states to use to encourage private investment in the construction and rehabilitation of privately owned apartments dedicated for 30 years or more at restricted rents to families with incomes of 60 percent of area median income or less. In creating the Housing Credit in 1986, Congress recognized that apartments simply cost too much to build, without some form of development tax incentive or subsidy, to rent at rates affordable to low-income families.

The Housing Credit is an enormous success. Since 1986, it has financed 1.5 million apartments to respond to the severe and growing shortage of decent, safe, and affordable housing for low-income Americans—working families, seniors, the homeless, and people with special needs all across the country. Each year, the Housing Credit finances 115,000 more apartments.

Often, Housing Credit tenants earn far less than federal income limits permit; in 1997, the GAO found the average Housing Credit tenant earned 38 percent of area median income. A majority of Housing Credit properties are dedicated to low-income use for periods longer than 30 years, many for 50 years or more.

The Housing Credit works because it allows states, not the federal government, to decide how to respond most effectively to their housing needs. It also harnesses the resources and discipline of the private sector, attracting $6 billion in private sector capital annually and giving the private sector a stake in the success of the housing this investment builds.

The Housing Credit has become more and more efficient over time, due in large part to Congress' 1993 decision to make the Housing Credit permanent and increased corporate investment. Prices investors pay for Housing Credits have risen approximately 50 percent since the program's creation in 1986, increasing the amount of equity capital that goes directly into affordable housing production.

The Housing Credit is not only good for housing; it is good for the economy. Housing Credit apartments account for up to 40 percent of all apartment production annually. Each year, the construction and operation of Housing Credit properties generates approximately $8.8 billion of income for the economy, creates 167,000 jobs, and produces $1.35 billion in revenue for cash-strapped local governments.

The Housing Credit enjoys strong, bipartisan support in the Congress. As recently as December 2000, Congress increased annual Housing Credit authority by 40 percent. Over 85 percent of the Congress, with nearly equal proportions of Republicans and Democrats, cosponsored the legislation calling for that increase.

We offer a simple solution to the problem the dividend proposal presents the Housing Credit. Treat Housing Credits as taxes paid, as the proposal treats foreign tax credits.

We look forward to your help in protecting this vital supplier of the nation's affordable rental housing. We stand ready to assist you in any way we can. If you have questions about the Housing Credit or the Ernst & Young report, please do not hesitate to call me.

Sincerely,

Barbara J. Thompson

Barbara J. Thompson
Executive Director

Enclosure
cc: Assistant Secretary Pamela Olson
Deputy Assistant Secretary Gregory Jenner

NATIONAL TAX DEPARTMENT

The Impact of the Dividend Exclusion Proposal on the Production of Affordable Housing

Commissioned by

NCSHA

National Council of State Housing Agencies

February 2003

ERNST & YOUNG

Quality In Everything We Do

ERNST & YOUNG LLP

Table of Contents

This report has been prepared by the Quantitative Economics and Statistics and the Tax Credit Investment Advisory Services groups of the National Tax Department of Ernst & Young LLP. Ernst & Young has been retained solely to consider the potential impact of the Administration's dividends exclusion proposal, as currently structured, on the production of affordable housing financed through the Low Income Housing Tax Credit program. We express no view on the broader merits of the proposal.

List of Exhibits

Executive Summary

Overview

On January 7, 2003, the Bush Administration released a $694 billion job creation and economic growth package that would significantly change the manner in which individual taxpayers are taxed. The centerpiece of this package is a proposal to integrate corporate and personal income taxes so that corporate earnings are taxed once and only once.

As currently structured, the proposal would have the unintended consequence of significantly reducing the effectiveness and efficiency of Low Income Housing Tax Credits (Housing Credits), which are one of the nation's primary tools to create and preserve affordable rental housing for low-income families and individuals. To assess this concern, the National Council of State Housing Agencies engaged Ernst & Young to quantify the proposal's potential impact on the production of affordable housing. We were not requested to study the broader implications of the dividend exclusion proposal for the economy as a whole; therefore, no opinion regarding such implications is expressed by this study.

Key Findings

- Our analysis estimates that 40,000 fewer affordable rental units could be created each year (a 35 percent drop in Housing Credit program production) if the proposal is enacted in its current form, affecting more than 80,000 people annually.

- The dividend exclusion proposal would not change the corporate income tax liability of corporate investors, who account for 98 percent of all Housing Credit equity. However, since Housing Credit investments will have the effect of decreasing the tax-free character of corporate dividends received by shareholders, these investments will become less attractive than alternative investments. As a result, some corporate investors will reduce the amount of capital they invest in housing credit properties or lower the price they are willing to pay for the credits, thereby reducing the efficiency of the credit.

- Housing Credit developments are financed with much higher levels of equity financing than conventional apartment projects. A reduction in the amount of equity financing will make many affordable housing properties economically infeasible. Properties in low-income neighborhoods, isolated rural areas, and high-cost urban areas may be disproportionately affected.

- The Housing Credit program has been a remarkably efficient mechanism for raising private sector equity for the development of low-income housing, attracting approximately $6 billion of investor capital and creating well over 100,000 affordable housing rental units each year. Housing Credit investment could fall by $1.1 billion if the current proposal is enacted.

Executive Summary (continued):

- Due to uncertainty over the proposal as currently structured, some corporations have indicated that they are deferring Housing Credit investment decisions pending Congressional action. This has destabilized the Housing Credit equity market and is likely to reduce affordable housing production in the short-term.
- Tax-exempt bond financing, which is present in 42 percent of Housing Credit properties, is likely to become more expensive as a result of the proposal, exacerbating the production loss estimates shown above.
- Other congressionally authorized community development incentive programs involving corporate investment, including New Markets Credits and Historic Rehabilitation Credits, along with the Administration's proposed Single-Family Housing Tax Credit program, would also suffer under the proposal as it is currently structured.

Possible Solution

- A modest change to the current proposal could ameliorate most of the adverse impact on the housing credit program while maintaining the principal economic benefits of the dividend exclusion: treating Housing Credits as taxes paid, similar to the proposed treatment of foreign tax credits.

I. Impact of the Administration Proposal

A. Explanation of the Proposal

On January 7, 2003, the Bush Administration released a $694 billion job creation and economic growth package that would make significant changes to the manner in which individual taxpayers are taxed. The centerpiece of this package is a proposal to integrate the corporate and personal income taxes so that corporate earnings are taxed once and only once. Under the current "classical" system, earnings taxed at the corporate level that are distributed as dividends to individuals are then taxed again at the individual shareholder level, creating "double taxation." The proposal would allow corporations to pass dividend distributions from earnings previously taxed at the corporate level to its shareholders on a tax-free basis. The plan would also reduce capital gains taxes by treating taxed earnings reinvested in the company's business as "deemed dividends," which are explained more fully below. Significantly, distributions of earnings not previously taxed at the corporate level, including due to corporate tax credits, would continue to be taxable at the shareholder level.

To calculate the amount of corporate income that is eligible for tax-free distribution to shareholders, a corporation would determine how much of its income has been fully taxed. The excludable dividend amount (EDA) is computed as follows, where U.S. CIT refers to corporate income taxes: [1]

$$\text{EDA} = \text{U.S. CIT} / 0.35 - \text{U.S. CIT}$$

In other words, every dollar of corporate tax payment would shield $1.86 of shareholders' income from tax. If a corporation distributes dividends up to the full amount of its EDA, all dividends are excluded at the individual shareholder level. To the extent that a corporation does not distribute the full EDA as dividends, the remainder of the EDA (called the retained earnings benefit adjustment or REBA) increases the shareholder's basis by the amount retained per share.[2] If a corporation pays dividends in excess of the EDA, the excess distribution would first be applied to the cumulative retained earnings benefit adjustment (CREBA), and would then be taxable at the individual shareholder level. Shareholders would receive information on the amount of excludable dividends and basis increase each year on IRS Form 1099.[3]

B. Impact of Proposal on Low-Income Housing Credit Investments

Shareholders in corporations that pay tax on all of their income will receive full relief from the tax on dividends. Shareholders in corporations that participate in congressionally authorized tax

---

[1] A corporation's U.S. taxes include the total tax amount after credits reflected on its U.S. federal income tax return filed during the prior calendar year, but including taxes offset by foreign tax credits.

[2] A shareholder would be able to adjust the purchase price ("basis" in the stock) upward if the company retained earnings instead of paying dividends. For example, a shareholder purchases a stock for $10 and holds the stock for two years. During each of these years, the company retains earnings that result in a $1 increase in basis. After two years, the shareholder sells the stock for $15. The capital gains tax would apply to the $3 gain ($15 minus the new basis, $12) rather than the $5 gain ($15 minus the original buy price, $10).

[3] U.S. Department of Treasury, Office of Public Affairs. January 14, 2003. KD-3761. "Fact Sheet: Ending the Double Tax on Corporate Earnings." Available from: http://www.ustreas.gov/press/releases/kd3761.htm.

incentive programs, however, will find themselves not fully relieved of those taxes—either through continued taxation of dividends or, more commonly, continued capital gains tax on the ultimate disposition of their shares. A portion of the tax relief afforded today through participation in Low Income Housing Tax Credit (Housing Credit) investments would not receive the benefit of the dividend exclusion at the shareholder level under the current proposal, thereby diminishing the incentive to invest. The issue at hand is the *relative* difference in the impact on corporations (and their shareholders) that invest in tax-advantaged incentives vis-à-vis those who do not.

Why Do Corporations Invest in Housing Credits?

Corporations make these investments for several reasons. First and foremost, Housing Credit investments allow companies to lower their effective tax rates and increase after-tax earnings. Corporations with cash surpluses view the yield and risk profile from housing credit investments to be superior to their investment alternatives (including reinvestment in their own businesses). In connection with this report, Ernst & Young surveyed some of the largest Housing Credit investors. Nine out of ten ranked financial considerations as their most important reason for investing.

Some Housing Credit investors (an estimated 43 percent) are subject to the Community Reinvestment Act (CRA), which provides an additional investment incentive since Housing Credits usually receive favorable consideration under the investment test component of the CRA. Regulatory considerations were ranked as the second most important reason for investing, although only one investor cited it as the most important reason.

In the case of any given corporate investor, its analysis of the impact of the dividend exclusion proposal and its decisions regarding continued investing will vary widely depending on many factors. Our survey also polled investors about whether their level of investment would change if the proposal were enacted (and without a change in investment pricing.) Results varied significantly, with some indicating they would decrease their investment activity (40%), some indicating they would maintain investment activity (20%), and some indicating they were not yet certain (40%).

In order to demonstrate the impact of the proposal, we have analyzed the effect of a representative corporate Housing Credit investment in Exhibit I-1 on page 5. In this analysis, we have compared the Housing Credit investment to a hypothetical equivalent taxable investment that provides the same after-tax yield. Under current law, the net after-tax cash flows from each investment are identical, both to the corporation and, ultimately, to its shareholders. Under the proposal, however, the same Housing Credit investment actually results in a negative combined corporate and shareholder return on investment (ROI), while the same alternative investment actually increases in value, since the shareholder will no longer pay tax. Finally, we show that a repricing of the tax credit investment, reducing equity available to the housing properties by approximately 20%, is necessary to preserve the economic result. Appendix A provides a more detailed analysis.

The current dividend exclusion proposal takes away some of the advantage of corporate tax credits by reducing the tax benefits of the dividend exclusion to corporate shareholders. Each $100 of corporate tax credit reduces the excludible dividend amount by $185.71. If the shareholders losing the benefit of the excludible dividend amount have an average marginal tax rate of 10 percent on capital gains, they would lose $18.57 of tax benefits by the corporation's investment in Housing Credits rather than alternative taxable investments.

The loss of shareholder tax benefits is tied to the amount of the corporate tax credit. However, some credits, such as Housing Credits, provide the corporate investor with significantly less net benefit than the full tax credit, because of the costs of obtaining the credit. Thus, the net benefit of Housing Credits, if a corporate investor pays $92 for $100 of credit, is only $8. The $92 cost of the Housing Credit goes to equity financing of the affordable housing production, so low-income tenants can have housing at lower rents.

Exhibit I-1: Example of Effect of Dividend Exclusion Proposal, As Currently Structured, on Housing Credit Pricing

Illustrative Example	A: Housing Credit Under Current Law	B: Equivalent Taxable Investment Under Current Law	C: Same Housing Credit Investment Under Proposal	D: Equivalent Taxable Investment Under Proposal	E: Repriced Housing Credit Investment Under Proposal
Housing Credit	$100.00		$100.00		$100.00
Corporate Investment Amount	$92.00	$92.00	$92.00	$92.00	$73.43
After-Tax Corporate Income	$8.00	$8.00	$8.00	$8.00	$26.57
Return on Investment (ROI) Before Shareholder Taxes	8.7%	8.7%	8.7%	8.7%	36.2%
Shareholder Tax Before Housing Credit EDA Reduction	$1.76	$1.76	$0.00	$0.00	$0.00
Reduced Excludible Dividend Amount (EDA)	$0.00	$0.00	$185.71	$0.00	$185.71
Shareholder Loss of Tax Benefits from Reduced EDA	$0.00	$0.00	$18.57	$0.00	$18.57
Return After All Taxes	$6.24	$6.24	($10.57)	$8.00	$8.00
ROI After Shareholder Taxes	6.8%	6.8%	(11.5%)	8.7%	8.7%
Percentage Reduction in Housing Credit Equity					(20.2%)

Notes: Assumes a 35% shareholder ordinary tax rate and a 10% effective shareholder capital gains tax rate, resulting in an effective rate of 22%, assuming a dividend payout of 47.5%. The dividend exclusion affects the amount of taxable capital gains for this incremental investment. Also, assumes the corporate investor has other investments and taxable income beyond the Housing Credit. See Appendix A for a more detailed calculation.

As can be seen in the simple example in Exhibit I-2 on the next page, where a corporation pays 92 cents on the dollar for Housing Credits, the loss of shareholder tax benefits can be greater than the net benefits at the corporate level. In this example, the $8 of corporate net benefit from the credit is more than offset by the loss of shareholder tax benefits of $18.57. This would make Housing Credits unattractive investments at their current price.

Exhibit I-2: Explanation of Column C: Net Benefit Reduction for Housing Credits at Current Pricing

$ 100.00	Gross benefit of Housing Credit
$ 92.00	Housing Credit investment by corporate investors, which serves as equity finance
$ 8.00	Net Benefit before proposal for Housing Credit where investors pay 92 cents on the dollar for Housing Credits
$ 185.71	Reduction in excludible dividend account for corporate shareholders from investment in Housing Credits rather than taxable investments
$ 18.57	Reduction in shareholder tax benefit from investment in Housing Credits rather than taxable investments, assuming reduction is in lower basis of capital gains and an effective marginal tax rate on capital gains of 10 percent
($ 10.57)	Net benefit of Housing Credit investment compared to alternative taxable investment after dividend exclusion proposal, as currently structured, with no change in pricing
(11.5%)	Return on Housing Credit investment after all taxes without repricing of the Housing Credit investment under the dividend exclusion proposal, as currently structured

An alternative taxable investment of $92 could generate an $8 after-tax benefit to the corporate investor, and pay out all of the $8 tax-free under the proposal, for an 8.7% return on investment. In order for Housing Credits to provide a similar after-tax return to corporate investors and their shareholders, the corporate investor would need to reduce the price of $100 of tax credits to $73.43 to provide a comparable 8.7% after-tax return to its shareholders (assuming a 10% effective capital gains tax rate).

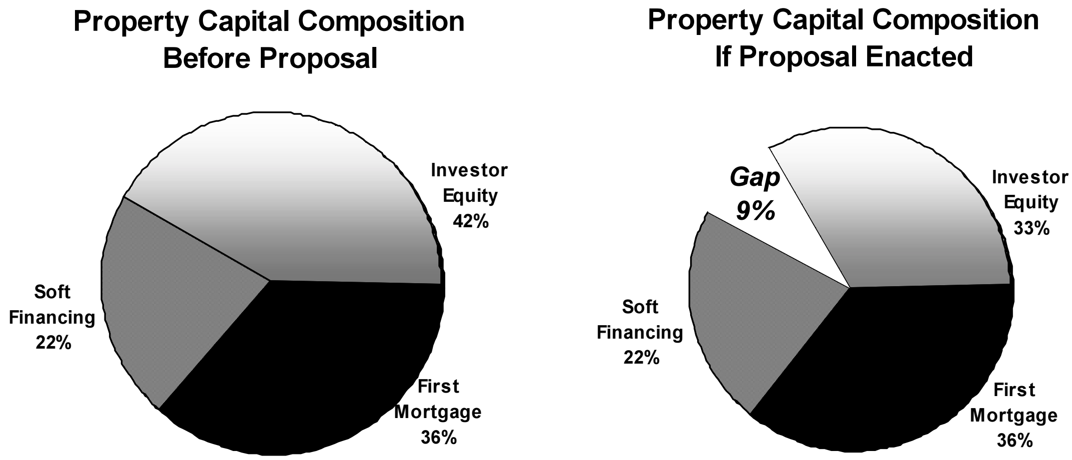
The decline in the corporate investment from $92 to $73.43 for $100 of Housing Credits is a 20% reduction in the equity financing available from the Housing Credits. The smaller equity finance creates a gap in the financing of affordable housing credit production that must be filled by other "soft debt," higher rents to the extent feasible and allowable, or production expense reductions.

C. Impact of Pricing on Affordable Housing Production

The effectiveness and efficiency of the Housing Credit is in part a function of the price that investors are willing to pay for it. Higher prices allow state Housing Credit allocating agencies to spread the equity funding arising from the credits more broadly, increasing the quantity of affordable units produced. (See Section II. B for a more detailed discussion.) Conversely, the decline in pricing as a result of the proposal will decrease the efficiency of the Housing Credit, reducing the number of units produced.

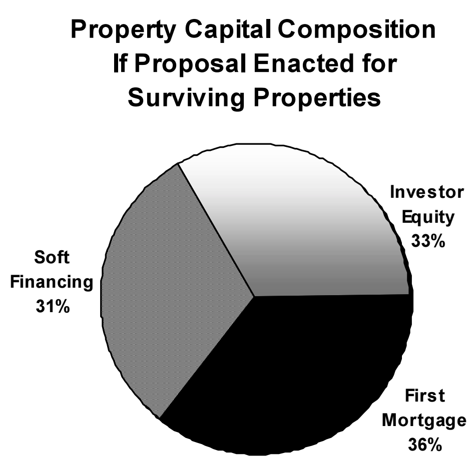
A 21 percent decline in Housing Credit pricing will reduce the total amount of equity to these properties by $1.1 billion annually, creating a significant funding gap in the development budget for these properties, as shown in the following chart.

Exhibit I-3: Components of Property Financing Before Proposal and During Interim



There are limited options available to close this funding gap. The amount of credit allocation to each property cannot be increased, since it is fixed by the formula mandated by the Internal Revenue Code.[4] The amount of first mortgage financing, generally calculated to provide a 1.15 debt coverage ratio, is also unlikely to change, since the reduced equity will not affect operating revenue and expense assumptions and, therefore, will not allow the property to support additional debt service. Accordingly, the most likely source of financing to close the funding gap would be "soft financing," which is typically administered by state and local governments in the form of loans with deferred debt service, repayable only from available cash flow.

Exhibit I-4: Components of Housing Credit Property Financing After Proposal



To fill the gap, an increase in the level of soft financing from an average 22 percent of total property financing to 31 percent would be required (a 41 percent increase.) Given their current budgetary crises, state and local governments will not likely be able to fund the $1.1 billion financing gap. Financing for an individual property can be increased, however, by reallocating it

[4] Internal Revenue Code Section 42.

away from another property. If the total amount of available soft debt financing remaining constant and each property requiring more soft debt to close the funding gap, fewer properties will be developed. Our calculations indicate that soft debt financing could fill the financing gap for 65 percent of Housing Credit units annually at the expense of the remaining 35 percent. Consequently, the annual production of affordable rental units will fall.

As a result of the currently structured proposal, we estimate that the number of affordable housing units produced each year would fall by approximately 40,000 units, or 35 percent of program production, affecting over 80,000 tenants annually.

Some properties rely more heavily on Housing Credit equity than others. The Housing Credit rules allow a larger allocation of Housing Credits to properties located in areas with high development costs or low household income levels.[5] These areas are typically distressed urban areas, isolated rural areas, and lower income neighborhoods. This additional subsidy allows these properties to get built despite the additional development challenges inherent in their locations. Due to their heavier reliance on Housing Credit equity, the funding gap created by the proposal is likely to be higher than the average. If soft debt financing providers attempt to maximize unit production when reallocating their subsidy, these kinds of properties will likely not get built due to their higher cost.

D. Additional Implications from the Impact on the Tax-Exempt Bond Market

The analysis in this report examines the effect of the dividend exclusion proposal, as currently structured, on Housing Credit financed rental projects. Approximately 42 percent of the units allocated Housing Credits in 2001 combined these credits with tax-exempt financing.[6]

Tax-exempt financing enables Housing Credit rental properties to borrow at lower interest rates than traditional taxable financing. Tax-exempt financing interest rates have been approximately 12 percent lower than comparable taxable interest rates.[7] The lower interest rate, combined with the Housing Credit equity enables certain developments to be feasible with affordable rents.

The dividend exclusion proposal would have three adverse effects on tax-exempt financing. First, tax-exempt bonds will become less attractive investments relative to corporate equity. Households, either directly or through mutual fund investments, will earn corporate dividends and capital gains tax-free (to the extent distributed out of previously-taxed corporate earnings). Investors looking for tax-free income will find corporate equity, particularly dividend paying stocks, more attractive under the proposal. Since tax-exempt bonds have pretax yields below comparable taxable yields, investors pay an implicit marginal tax rate of 12 percent or more when investing in tax-exempt bonds. By reducing the shareholders' marginal tax rate to zero on corporate equity income, the proposal will result in a shift toward corporate equity and away from tax-exempt municipal securities. Although the exact effect on tax-exempt interest rates is not clear, the definite trend is upward. This is one of the intended consequences of the proposal.

---

[5] Internal Revenue Code Section 42(d)(5)(C).
[6] State HFA Factbook: 2001 NCSHA Annual Survey Results.
[7] Ernst & Young calculation using historical interest rates on state and local bonds vs. 20- and 30-year treasury rates.

Second, the dividend exclusion proposal will have an even greater effect on corporate investors in tax-exempt securities. Unlike individual investors, corporate investors are also affected by the loss of shareholder tax benefits from investing in tax-exempt securities. Similar to the effect of Housing Credits on shareholders, the tax-exempt bond interest received by corporations will carry an additional tax cost to shareholders. When considering tax-exempt bonds, banks and insurance companies will not only factor in the implicit marginal tax rate from the lower yield and the loss of interest deductions from special "proration" rules, but also the loss of shareholder tax benefits. This will make it unlikely that current corporate tax-exempt bondholders will find tax-exempt bonds attractive investments. This effect is likely to be another unintended consequence of the proposal to reduce the double taxation of corporate income.

The exit of corporate investors from tax-exempt securities, combined with the reduced demand by households, will result in yields increasing significantly. Higher yields on tax-exempt securities will compound the financing gap beyond the shortfall resulting from the reduced Housing Credit equity investment. Although the magnitude of the effect of the dividend exclusion on Housing Credit and tax-exempt financed property is not estimated here, it is definitely adverse and is in addition to the unintended consequences of the Administration's proposal on conventionally financed Housing Credit properties.

A third indirect effect of the dividend exclusion proposal would be a reduced ability of state and local governments to provide soft debt financing to fill the gap involved in these projects under current law and an even larger gap after the proposal. The dividend exclusion will exacerbate the difficult budget deficit situations facing state and local governments in two ways. First, tax-exempt bond interest rates will increase, raising their costs. Second, the dividend exclusion will reduce state and local income tax revenue to the extent that these governments piggyback on the federal definition of adjusted gross income. State and local governments' ability to provide the same amount of current soft debt financing will be in question, given their deteriorating budget situations. It is highly unlikely that state and local governments will be able to provide additional soft debt financing to fill the larger gap resulting from the dividend exclusion.

E. Possible Solution

Calculating the EDA using corporate tax liability prior to the application of tax credits, rather than after, would retain the benefits of ending double taxation, while minimizing the impact on the successful Housing Credit program. This change would reduce most of the negative impact on shareholders associated with the use of the credit. The calculation of the EDA would then be:

$$\text{EDA} = (\text{U.S. CIT prior to tax credits}) / 0.35 - (\text{U.S. CIT prior to tax credits})$$

The rationale behind this treatment is that Congress, by enacting tax incentive legislation, has created a system designed to leverage private equity into areas traditionally underserved by investors, and often funded by direct governmental appropriations. The discipline imposed by this private funding has improved the delivery of affordable housing to those most in need. Since the tax credits are attracting private equity in lieu of using direct tax funds to meet the targeted needs, the credits should be treated as the equivalent of tax payments without violating the principle of elimination of double taxation.

Although treating Housing Credits in this way would still leave some adverse impact on the Housing Credit market and unit production, the effect would be greatly minimized relative to the disruption were there no change in the proposed treatment of Housing Credits. The remaining effect is due to a reduction in the value of benefits arising from tax deductions rather than tax credits as well as the impact on tax-exempt bond interest rates discussed above.

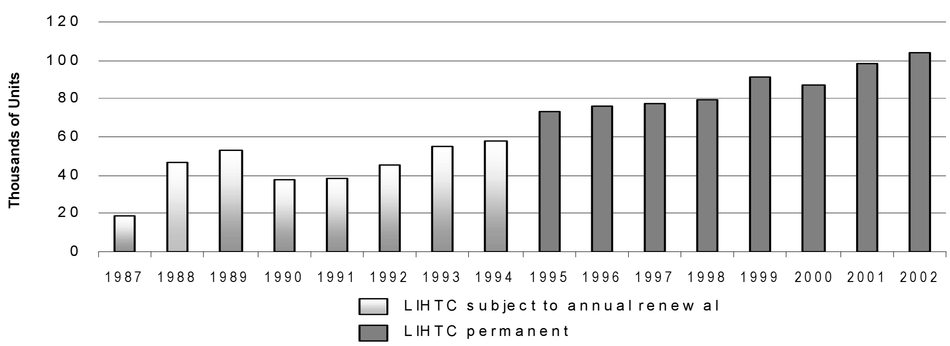
The impact of the dividend exclusion proposal on tax-exempt bond financed Housing Credit projects would not be remedied fully by treating Housing Credits in the same way as the foreign tax credit under the dividend exclusion proposal.

II. Success of the Low-Income Housing Credit Program

Since its enactment in 1986, the Housing Credit program has grown to become the leading tool for the development of affordable rental housing. The program allows participants to claim tax credits in exchange for producing affordable rental housing made available to low-income households. To date, well over one million affordable rental units have been created for families and individuals throughout the country.[8] The demand for these units is over-subscribed. In 2001, 7.1 million low-income rental households faced *severe* housing affordability problems (spent more than 50 percent of their income on rent).[9] Recent data indicates that the problem is growing - the problem has worsened by 64 percent between 1997 and 2001.[10]

Exhibit II-1 shows the number of Housing Credit units placed in service annually.[11] The early years of the program saw lower annual unit production for several reasons, including the uncertainty caused by subjecting the program to annual reauthorization and the high cost of raising capital from individual investors.[12] In addition to these higher costs, individual investors are subject to a number of limitations on their ability to use tax credits efficiently, including the passive activity limitations and the alternative minimum tax rules. Subsequent to making the program permanent in 1993, the efficiency of the program soared due to increased investor confidence and the entry of corporate investors into the Housing Credit marketplace.[13]

Exhibit II-1: Quantity of Low-Income Housing Units Placed in Service by Year



Source: HUD Housing Credit Database (1987 – 1999) and Ernst & Young Estimates (2000 – 2002).

---

[8] HUD Housing Credit Database and State HFA Factbooks from NCHSA Annual Surveys.

[9] "American Housing Survey for the United States: 2001", U.S. Census Bureau

[10] "Americas Working Families and the Housing Landscape: 1997 – 2001," Center for Housing Policy/National Housing Conference, Volume 3, Issue 2, November 2002.

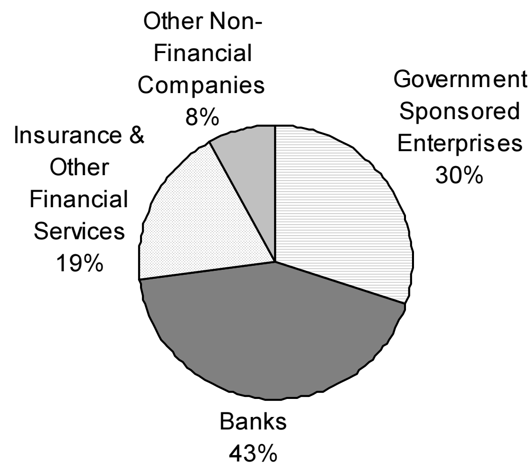
[11] From the U.S. Department of Housing and Urban Development's Housing Credit Database through 1999. Since this database has not been updated for subsequent years, we have estimated production for these years based on housing credit allocation data from NCSHA's State HFA Factbooks for 2000 and 2001 and historical housing credit utilization rates.

[12] Limitations on the amount of Housing Credits that can be claimed by individual investors required that large numbers of individual investments be pooled, which proved to be far more expensive than raising funds from a few corporate investors, who can make more efficient use of the credit and who invest much larger dollar amounts.

[13] For a more detailed discussion of changes in the equity market, see "The Low-Income Housing Tax Credit: The First Decade," by E&Y Kenneth Leventhal Real Estate Group, 1997.

Today, corporations account for nearly all of the approximately $6 billion of annual Housing Credit investment.[14] The current market for Housing Credits is dominated by financial services companies, including banks, insurance companies and government-sponsored enterprises such as Fannie Mae and Freddie Mac. As noted previously, some financial services companies are subject to regulations that may provide incentives to invest in affordable housing beyond purely economic reasons.[15] Our estimate of the relative market share of each sector is shown in Exhibit II-2.

Exhibit II-2: Relative Market Share of Housing Credit Investors



Source: Ernst & Young estimate of 2002 Housing Credit market.

A. How the Housing Credit Works

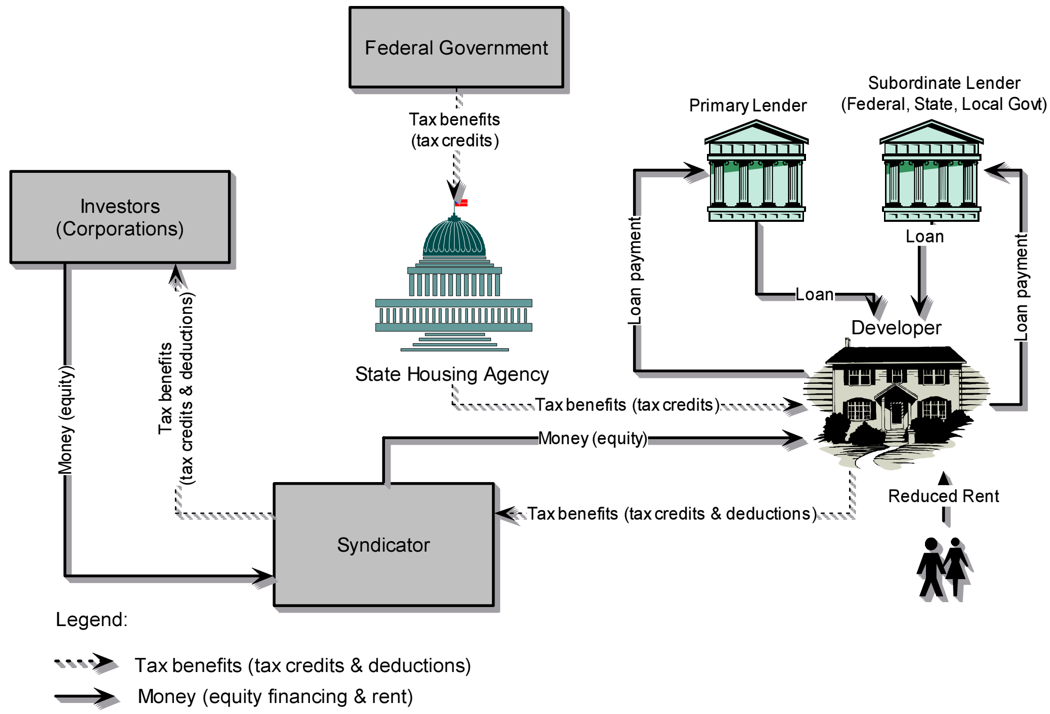
The Housing Credit program works by placing development and investment responsibility in the hands of the private sector, with government providing the subsidy and program oversight. Exhibit II-3 shows the flow of funds and tax benefits among the parties.

The program, set forth in Section 42 of the Internal Revenue Code, provides each state with the authority to issue Housing Credits in proportion to the state's population. (In 2002, the volume limitation on credit allocations was increased to $1.75 of Housing Credits per capita.) Each state is responsible for assessing its own housing needs and distributing the credits as efficiently as possible to private developers. States may target particular geographic areas, tenancies (e.g., families, senior citizens), special needs populations or a variety of other characteristics (e.g., low-income families in need of deep rental subsidies) to ensure that the state's greatest housing needs are being met. Developers and community-based organizations compete for Housing Credits in a process that helps ensure transparency and economic feasibility.[16]

---

[14] Ernst & Young estimate of 2002 Housing Credit investments.
[15] Banks are subject to the Community Reinvestment Act and are regulated by the OCC, the OTS, the Federal Reserve Bank or the FDIC. Congress and HUD oversee the GSEs.
[16] Properties utilizing tax-exempt bond financing are eligible for Housing Credits through a noncompetitive process, but are still subject to certain state-level reviews.

Exhibit II-3: The Mechanics of the Housing Credit



Once Housing Credits have been secured from the state, an investor must be secured to make an equity investment in the property in "exchange" for the Housing Credits. It is this equity that funds a substantial portion (42 percent, on average) of the property's development cost.[17]

Corporations typically invest through funds established by intermediaries known as syndicators. These organizations aggregate Housing Credit properties into funds sizeable enough to be attractive to large corporations, typically in the $50 to $150 million range. These intermediaries act much like mutual fund managers: they pool funds from a group of investors, evaluate and acquire the underlying investment assets and provide ongoing management services.

In addition to the Housing Credit equity requirement, developers must also obtain additional sources of financing to fund the remaining 58 percent of development costs. First mortgage financing funds 36 percent of these costs, on average, and is typically provided through a bank or mortgage company. The balance is principally funded through subordinate financing or "soft loans." State and local governments are the source of 70 percent of this gap financing.[18]

By contrast, market-rate, multifamily properties typically have 60%–80% first mortgage financing rather than the 36 percent first mortgage leverage described above. It is ultimately the savings from the reduced leverage (in the form of reduced debt service) that allows tax credit properties to charge reduced rents to its residents.

---

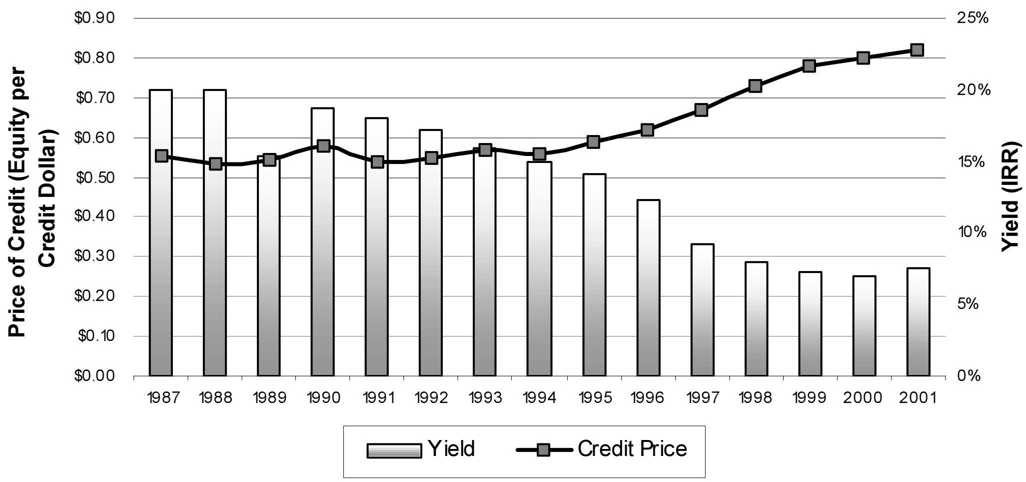
[17] Ernst & Young analysis of industry data for allocated credits and those available through tax-exempt bond use.
[18] The Low-Income Housing Tax Credit: An Analysis of the First Ten Years, Cummings and DiPasquale, published in Housing Policy Debate, Volume 10, Issue 2, 1999.

B. The Efficiency of the Low-Income Housing Credit

Over the 16-year history of the Housing Credit program, the value of Housing Credits has steadily increased, resulting in greater numbers of affordable units being built at even lower rents than those mandated by the program.

As Exhibit II-4 shows, the willingness of investors to accept declining yields of Housing Credit investments has translated into greater equity investments per dollar of Housing Credit, reaching an average of $0.82 at the property level (which equates to $0.92 at the investment level) in 2001. The acceptance of reduced yields reflects the low-risk performance history of Housing Credits and the perception that its Congressional support translated into low legislative risk.

Exhibit II-4: Average Tax Credit Pricing and Yield, 1987–2001



Source: Credit price from Ernst & Young LLP, Understanding the Dynamics: A Comprehensive Look at Affordable Housing Credit Properties; Yield from Ernst & Young database.

The increased value in the credits over the last several years has allowed states to do two things: build even more housing units, and more deeply target lower-income and special need households.

Exhibit II-4 demonstrates the results of the increased "buying power" of the Housing Credit in terms of the increasing price trend. Annual affordable unit production increased over this period of constant credit allocations (see Exhibit II-1). This was despite a contemporaneous reduction in buying value due to increasing project construction and development costs. In other words, more affordable units were produced per year due to the increased value of the credit.

In addition to increasing the number of units produced per Housing Credit dollar, states have also been able to target poorer households. The Housing Credit rules require that a minimum of 20 percent of a development's units must be rented to households at or below 50 percent of the area median income or 40 percent of its units are rented to households at or below 60 percent of the area median.[19] In practice, most Housing Credit developments are at or near 100 percent affordable.[20]

Over time, states have also been able to use the Housing Credit program to subsidize even more affordable units, avoiding the problem of serving only those at or near the 50%–60% thresholds. Average state allocation results for 2001 were as follows:

- 49% of units were earmarked for 51% – 60% of Area Median Income (AMI);
- 30% were 41% – 50% of AMI;
- 9% were 30% – 40% of AMI; and
- 5% were below 30% of AMI.[21]

In practice, Housing Credit properties have performed better than these requirements, providing affordable housing to even lower-income households. Exhibit II-5 shows the distribution of tenant incomes across a sample of properties, with a mean income of 38 percent of the area median. Other studies have corroborated these findings.[22]

Deep Income-Targeting: The Case of California

Although the Housing Credit program requires that 40% of its units be below 60% of the area median income, states often encourage the targeting of even lower income households by favoring developments with lower income restrictions.

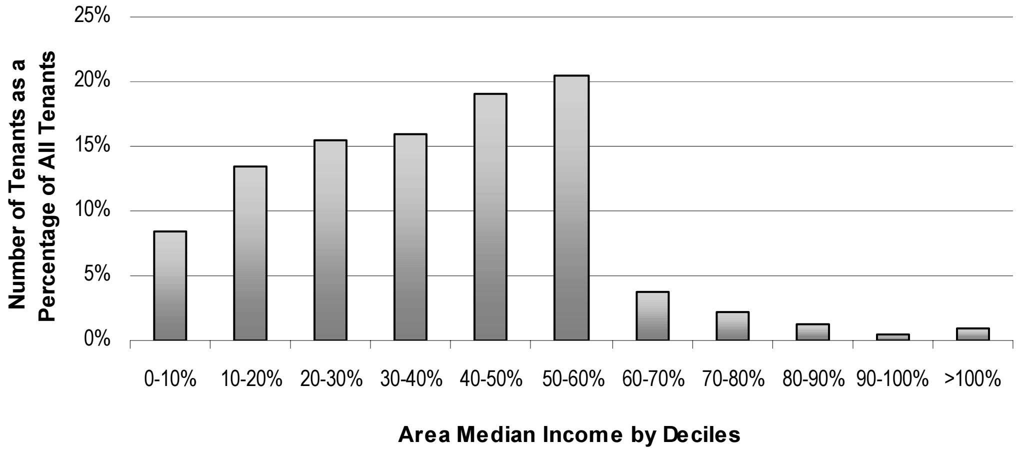
California, which accounts for 12% of all Housing Credits, has been a leader in promoting the use of the Housing Credit for lower income households. The state preferentially awards Housing Credits to developments with the largest percentage of units reserved for the lowest income households.[1] For 2001 allocations, California reported 8% of units were targeted to 51% – 60% of area median income households, 58% to 41% – 50% of the area median, 22% to 30% – 40% of the area median and 12% to households below 30% of the area median.[2]

In practice, units produced by the program are rented to households below even state requirements. The average Housing Credit unit reported household income of 36% of the area median.[3]

[1] California Tax Credit Allocation Committee Regulations Implementing the Federal and State Low Income Housing Tax Credit Laws, California Code Of Regulations, Title 4, Division 17, Chapter 1.
[2] State HFA Factbook: 2001 NCSHA Annual Survey Results.
[3] GAO/RCED-00-51R.

[19] Internal Revenue Code Section 42(g)(1).
[20] GAO/RCED-00-51R Characteristics of Tax Credit Properties.
[21] Source: State HFA Factbook: 2001 NCSHA Annual Survey Results.
[22] GAO/RCED-00-51R Characteristics of Tax Credit Properties.

Exhibit II-5: Housing Credit Tenant Incomes as a Percentage of Area Median Income



Source: "The Low-Income Housing Tax Credit: The First Decade," E&Y Kenneth Leventhal Real Estate Group, 1997.

Housing Credit properties have been kept affordable for these lower-income households through utilization of rental subsidies and through income targeting imposed by state Housing Credit allocating agencies, which has been possible due to the higher prices paid for credits in recent years. Included among these lower-income households are the homeless, disabled, and others with special needs who are typically less able to afford market-rate rents.

III. Conclusion

Our analysis indicates that the Administration's proposal to eliminate taxes on corporate dividends, as it is currently structured, will have a substantial adverse impact on the development of affordable rental housing. By reducing the attractiveness of Housing Credits to investors, the proposal as currently structured would reduce the efficiency of this important tool, resulting in a decline in the number of units produced and a decrease in the program's ability to target families with the lowest incomes. The financing gap created by the erosion in value will force those administering soft financing programs (state and local governments) to reallocate their limited subsidies, reducing the volume of affordable units produced.

Affordable housing production could fall by 40,000 units if the proposal is enacted as it is currently structured. This would affect the provision of new affordable housing units for over 80,000 people annually. Certain areas, including low-income neighborhoods, isolated rural areas, and urban areas may be disproportionately affected.

One solution would be to change the manner in which the EDA is calculated, by using corporate tax liabilities prior to the application of tax credits, including Housing Credits, rather than after. This treatment is similar to the manner in which foreign tax credits are treated under the current proposal and would mitigate many of the adverse tax consequences to investors and their shareholders. This approach would achieve the economic benefits from eliminating the double taxation of corporate income without undermining the nation's leading affordable rental housing program.

The current dividend exclusion proposal would also have adverse effects on related community development incentives. Other community development programs, including New Markets Tax Credits (IRC Section 45D) and Historic Rehabilitation Credits (IRC Section 47) would also be negatively affected by this proposal. Finally, the Administration's proposed single-family home ownership tax credit would, if enacted, be much less valuable as an incentive for increasing home ownership.

IV. Appendices

Appendix A: Impact of Proposal on Corporations and Shareholders

Appendix B: Sensitivity Analysis of the Adverse Price Effect

Appendix A: Impact of Proposal on Corporations and Shareholders

Exhibit A-1 shows the effect of the dividend exclusion proposal on the after-tax return from an investment in Housing Credits. The example simplifies the multiyear tax credit investment by displaying the entire investment period in net present value terms to illustrate the change in tax credit pricing necessary for the investments to be attractive in the future. The example shows how a corporation may choose whether to purchase an investment in Housing Credits or an alternative taxable investment.

Exhibit A-1: Detail of Effects of Current and Proposal Comparison

		Current Law:		**Currently Structured Dividend Exclusion Proposal:**		
	Item	**Housing Credit**	**Equivalent Taxable Investment**	**Housing Credit**	**Equivalent Taxable Investment**	**Repriced Housing Credit**
	Column:	*1*	*2*	*3*	*4*	*5*
Row:	**Corporation:**					
1	Net Income before investment	$100,000	$100,000	$100,000	$100,000	$100,000
2	Taxable net income from investment	$0	$122	$0	$122	$0
3	Taxable net income	$100,000	$100,122	$100,000	$100,122	$100,000
4	Corporate income tax	$29,000	$29,035	$29,000	$29,035	$29,000
5	LIHTC credit and investment loss benefits	$1,087	$0	$1,087	$0	$1,087
6	Tax net of credits and investment loss benefits	$27,913	$29,035	$27,913	$29,035	$27,913
7	Net after-tax earnings	$72,087	$71,087	$72,087	$71,087	$72,087
8	Investment amount (cost) after return of capital	$1,000		$1,000		$789
9	Net after-tax cash flow	$71,087	$71,087	$71,087	$71,087	$71,298
	Shareholders:					
10	Pre-tax corporate profit from investment	$87	$122	$87	$122	$298
11	After-tax corporate profit from investment	$87	$87	$87	$87	$298
12	Dividends received	$33,787	$33,787	$33,787	$33,787	$33,888
13	Excludable Dividend Amount (EDA)	NA	NA	$51,838	$53,923	$51,838
14	Shareholder taxable dividends	$33,787	$33,787	$0	$0	$0
15	Shareholder income tax liability	$11,826	$11,826	$0	$0	$0
16	Future change in capital gain from retained earnings	$37,300	$37,300	$37,300	$37,300	$37,411
17	Retained Earnings Benefit Adjustment (REBA)	$0	$0	$18,051	$20,136	$17,951
18	Future change in capital gains tax	$3,730	$3,730	$1,925	$1,716	$1,946
19	Total taxes paid at shareholder level	$15,555	$15,555	$1,925	$1,716	$1,946
20	Combined change in after-tax return	$55,531	$55,531	$69,162	$69,371	$69,352
21	Incremental shareholder tax from investment	$19	$19	$209	NA	$230
22	ROI before shareholder taxes	8.70%	8.70%	8.70%	8.70%	37.81%
23	ROI after shareholder taxes	6.79%	6.79%	(12.15%)	8.70%	8.70%

Comparison Under Current Law

Exhibit A-1 compares a hypothetical example of an investment in Housing Credits and an equivalent investment made in a fully taxable transaction under current law. It then shows how the desirability of the Housing Credit falls under the proposal, while the desirability of the taxable investment is enhanced. Finally, it shows how the amount of the equity being invested in Housing Credits would fall by 21% in order to maintain the equivalency of the two investments. The example reflects the composite attributes of typical corporate investors in Housing Credit transactions. It further assumes the marginal corporate shareholder (i.e., the shareholder which most influences corporate decision making by being the last willing to invest) has an effective capital gains rate of 10 percent. See Appendix B for a sensitivity analysis demonstrating the impact under other assumptions.

Columns 1 (investment in Housing Credits) and 2 (investment in an equivalent taxable alternative) show a situation in which the corporate investor earns an equivalent rate of return both before and after shareholder taxes. Line 5 represents the entire life cycle of the investment displayed in one net number that represents the net present value of the future stream of benefits. For the Housing Credit investment, these benefits consist mainly of tax credits and the tax savings represented by the real estate deductions. For the equivalent taxable investment, the benefits consist mainly of future cash returns, which will result in additional taxable income.

At the corporate level, an investment of $1,000 generates an 8.7 percent after-tax return under either alternative. The corporation invests $1,000 in return for $1,087 of tax credit benefits, consisting of the future tax credits and deductions (but no cash). Alternatively, the corporate investor could invest in a taxable investment (e.g., a bond) earning a comparable pretax return of 13.4 percent to earn an 8.7 percent after-tax return of $87.

This example uses a 29% corporate tax rate for both types of investments. The spread between the maximum corporate rate of 35% and this rate reflects the effect of variations in the tax code affecting various industries as well as the impact of prior investments in tax incentive programs under the current code. The after-tax cash flow of the corporate investor is the same for the two investments. With the alternative taxable investment, the cash flow is the same as the after-tax income ($71,087). With the Housing Credit investment, the corporate tax paid is reduced by the amount of the credit and loss benefits ($1,087), but the investor has also invested $1,000, so the cash flow is identical. It is important to note that Housing Credit investments provide a return in the form of tax savings, not cash. The taxable investment alternative includes a full return of capital in the form of cash. The corporation will make the same dividend payout decision (in this example, 47.5 percent of cash flow, which reflects the experience of a typical investor sample).

Under current law, the tax treatment of the two alternative investments at the shareholder level is identical. The $33,787 of dividends is subject to individual income tax. Assuming a 35 percent marginal tax rate on dividends results in a tax on dividends of $11,826. Since 52.5% of the corporate cash flow is retained at the corporate level, the value of the corporation, and thus the value of the stock, rises by $37,303. This increase in value is reflected in incremental increases in the capital gain to be recognized when the shareholder sells its stock. The future capital gains tax shown on line 18 uses an average tax rate of 10 percent, which reflects capital gains tax rates, sale deferral, charitable gifts and step-up in basis at death. The return on investment (ROI) on the two alternatives is 6.8 percent after shareholder taxes.

Comparison Under Proposed Law

Column 3 shows the effect of the proposed dividend exclusion on the return on the same Housing Credit investment. At the corporate level, the result is unchanged, since the proposal only impacts taxes at the shareholder level.

Shareholder taxes paid on dividends and shareholder capital gains on retained earnings are both affected. Under the proposal, only dividends distributed that exceed the sum of the excludable dividend allowance (EDA) and the cumulative retained earnings balance adjustments (CREBA) are taxed. Any portion of the EDA not distributed to shareholders, termed the "retained earnings benefits adjustment," or REBA, increases a shareholder's stock basis and reduces the future capital gains tax. In this example, the EDA is $51,838 with the Housing Credit investment, but $53,923 with the alternative investment. The difference of $2,085 reflects the disparity in taxes paid in the example. Because the EDA is calculated based on corporate taxes actually paid, there is a large effect created by any tax credits claimed. Since the corporation realizes only a small net benefit on its tax credit investment, the resulting $217 higher capital gains tax relative to the alternative investment makes the ROI actually negative. This effect is shown on lines 12 – 23.

In this example, the EDA exempts from tax the entire amount of dividend paid, but the lower EDA for the Housing Credit investment increases shareholder taxes on capital gains. This is shown in Lines 17 and 18, where the REBA is lower for the Housing Credit and thus the capital gains tax is $209 higher than the alternative investment. Since the corporation only netted $87 in after-tax cash flow from the investment, the ROI on the Housing Credit investment after the proposal has dropped below zero. The ROI on the alternative taxable investment has increased from 6.8 percent under current law to 8.7 percent under the proposal due to the reduction in the shareholder's capital gains tax.

The $209 of extra tax (relative to the alternative investment) at the shareholder level has effectively eliminated the financial incentive to make the Housing Credit investment.

Corporate investors would not find Housing Credit investments financially attractive under the dividend exclusion proposal at the current pricing, relative to alternative investments. An immediate effect of the proposal will be to make Housing Credit investments unattractive unless their pretax returns are brought back to equilibrium by lowering the price paid for the credits.

Repricing of the Housing Credit investment to Maintain After-Tax Yield

Columns 4 and 5 illustrate how corporation management may act to re-establish the yield parity between the taxable investment and the Housing Credit investment. In column 4, the same equivalent taxable investment achieves a better after-tax result than under current law, due to the dividend exclusion. The effect on shareholder taxation is limited to the change in future capital gains tax to be paid.

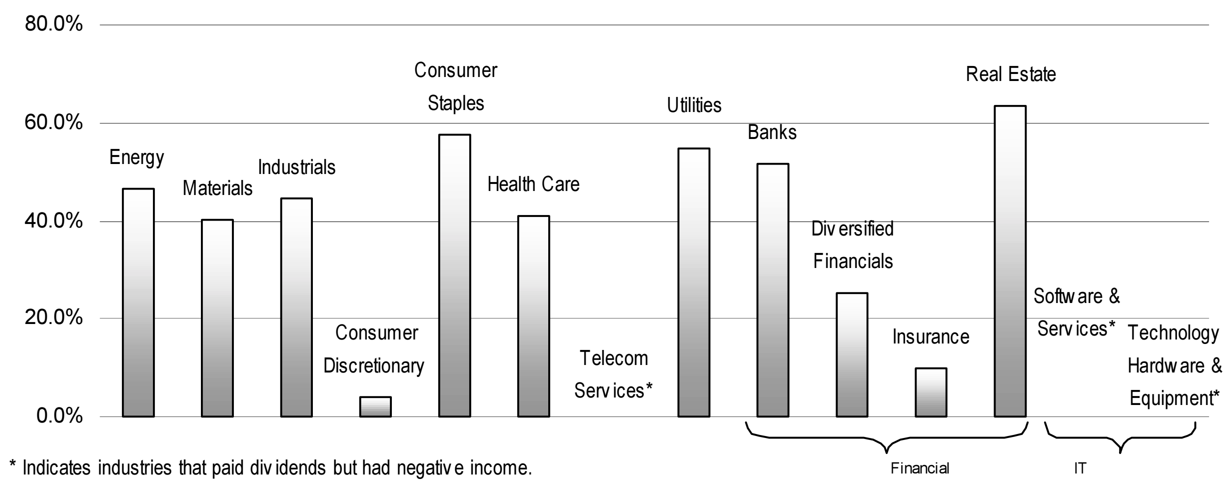
In column 5, line 8 shows that the price paid for the Housing Credit investment has been lowered to the amount that maintains the equivalency between the alternative investments. Given the parameters of this example, the price of the Housing Credit investment must fall by 21.1% in order to bring the ROI to a positive level and achieve the same after-tax yield for the corporation and its shareholders. Appendix B shows how the relative decrease in Housing Credit pricing to maintain parity varies under certain circumstances. The effect is, however, always negative – it always requires a decrease in Housing Credit pricing to keep the credit attractive relative to the taxable equivalent.

Corporate Dividend Characteristics

As previously mentioned, the impact of the dividend exclusion proposal is in part a function of the extent to which corporations pay dividends and the taxability of those dividends. Dividends are not taxable if they are paid to nonprofit institutions; federal, state, or local governments; public or private pension funds; or 401(k) or IRAs. William Gale, an economist at UCLA, estimates that only 46 percent of dividends paid out by the corporate sector in 2000 were subject to double taxation.[23] See Appendix B for a sensitivity analysis that demonstrates the impact of differences in shareholder taxability.

Exhibit A-2 illustrates the average percent of retained earnings paid out as dividends by industry. Financial services companies have historically paid a relatively high percent of retained earnings as dividends when compared to other industries. It is reasonable to project that publicly traded companies in general, and financial services companies in particular, will increase their dividend payouts if the Administration proposal is adopted.

Exhibit A-2: Average Dividends as a Percent of Net Income, 1996–2001[24]



Source: E&Y Calculations from Compustat 2001 Data.

[23] Gale, William. "About Half of Dividend Payments Do Not Face Double Taxation," Tax Notes, 11 Nov 2002, page 839.
[24] Average cash dividends paid on common stock as a percentage of net income before extraordinary items.

Corporate Management of Shareholder Tax Liability

Corporations are responsive to shareholder taxation. Studies have found that lower dividend taxation results in an increase in the dividend payout ratio. Lower shareholder taxes result in corporations responding by paying out more dividends. The growth of corporate share repurchase programs also reflects the sensitivity of corporations to shareholder taxation. Share repurchase programs substituted for dividend payouts provide shareholders with cash that was subject to the lower capital gains tax rate plus nontaxed return of capital rather than fully taxable dividends.[25]

As a result, we conclude that the loss of shareholder tax benefits as a result of investing in Housing Credits will affect the investment behavior of corporations. Based on past experience, it is realistic to estimate the effects of the dividend exclusion proposal by assuming that corporations take account of total taxes (shareholders' and corporate).

Any incentives that cause a corporation to change its behavior will result in some additional costs borne by the corporation. The incentive is thus the gross benefit less the additional cost of responding to the incentive. In the case of tax-exempt bonds, the benefit is the tax-exemption of the interest income, but the cost is the lower yield earned on tax-exempt compared to taxable securities. The lower yield is the equivalent of an implicit tax, or cost, which could be 12 percent or more of the investment return. In the case of the Housing Credit, the cost is the price that investors pay for the credit, which has reached as high as 92 cents on the dollar. The net benefit is only 8%–10% of the credit after the effect of depreciation and other tax deductions from the rental property.

---

[25] U.S Treasury Department, "Report of The Department of the Treasury on Integration of the Individual and Corporate Income Tax Systems: Taxing Business Income Once," January 1992, page 117.

Appendix B: Sensitivity Analysis of the Adverse Price Effect

The conclusions reached in this report flow from a conservative base case analysis that assumes that the dividend exclusion proposal will not increase the taxation of shareholders' corporate dividends. (See page 7 and Appendix A for more details.) The base case assumes that dividend payouts will average almost 48 percent of after-tax income, so the use of Housing Credits by the corporation will only affect shareholders' retained earnings balance adjustment (REBA). Investments in Housing Credits are assumed to reduce the basis adjustment of shareholders' stock, resulting in a lower return earned by taxable shareholders relative to an alternative investment.

The effect on the marginal shareholders will vary based on at least three principal factors: the dividend payout rate of the corporation, the effective capital gains rate of the taxable shareholders and whether the marginal shareholders are all shareholders or only taxable shareholders. Due to variation in corporate dividend payout policies and the heterogeneity of corporate shareholders, we show the potential adverse price effect for eight possible scenarios. This sensitivity analysis results in Exhibit B-1 are intended to illustrate the effect for different types of corporations and shareholders.

First, corporate dividend payout policy will determine whether use of the Housing Credit would not decrease shareholders' dividend and capital gain taxes or just shareholders' capital gains taxes as much as on alternative taxable investments. The right hand column of Exhibit B-1 shows the effect on pricing when the corporate dividend payout is high enough so that shareholder dividend taxes are not reduced as much as they otherwise would be under the dividend exclusion proposal. Because dividend taxes are at shareholders' ordinary tax rates, which are higher than capital gains tax rates, the impact is significantly larger when dividend taxation is affected. Some Housing Credit investors, including utilities, have high dividend payout rates, so that their taxable shareholders would be impacted significantly relative to alternative taxable investments. The price reductions that are necessary when dividend taxes matter range from 35 percent to 95 percent.

Second, corporate management will attempt to maximize the value of the firm to the marginal investor. It is possible that management may view the marginal investor as the taxable investors, or alternatively they may view all shareholders, including tax-exempt investors, as making decisions at the margin. A significant proportion of corporate equity is held by tax-exempt entities (such as pension funds and university endowments), recently estimated at 54 percent. The sensitivity analysis calculates the adverse price effect where the taxable investor is the marginal investor, and also where both tax-exempt and taxable investors are the marginal investor, where a blended tax rate is used. In the lower dividend payout case, the marginal investor makes a significant difference. If all shareholders are included and the taxable shareholders' effective capital gains rate is 10 percent, the price effect would be a 9 percent reduction, but where the marginal investor is the taxable investor and the effective capital gains rate is 10 percent, the price effect is a 21 percent reduction.

Finally, the effective tax rate on capital gains can have a significant effect. The sensitivity analysis presents results assuming a 10 percent and 20 percent capital gains tax rates. The 20% rate is the top statutory marginal capital gains rate on sale of investments held less than five years. A 10 percent effective capital gains rate is also presented to reflect the possibility of lower rates with longer holding periods, the benefit of tax deferral from taxation upon realization and the step-up in basis adjustment for stock donated to charities or held until death. Depending on the effective tax rate on capital gains, the adverse price effect where the corporate dividend payout is low and the marginal investor is the taxable investor, the price detriment would be 21 percent with a 10 percent effective capital gains rate and 47 percent with a 20 percent rate.

Exhibit B-1: Sensitivity Analysis

	Change in Housing Credit Pricing:	
Shareholder Determining Corporate Housing Credit Investment Decisions:	*Low dividend payout affects only capital gains tax*	*High dividend payout affects both capital gains tax and dividend tax**
All Shareholders Included:		
Taxable Have 10% ECGTR**	(9.2%)	(35.4%)
Taxable Have 20% ECGTR**	(19.3%)	(35.7%)
Only Taxable Shareholders Included:		
Have 10% ECGTR**	(21.1%)	(92.7%)
Have 20% ECGTR**	(47.0%)	(95.1%)

*Dividend Tax Rate of 35% assumed in all cases
**Effective Capital Gains Tax Rate

As shown in Exhibit B-1, the potential change in the efficiency of equity raised for affordable housing ranges from a 9.2 percent detriment to a 95.1 percent detriment. Under none of these scenarios will there be a completely neutral or positive effect. This decrease in the amount of equity raised for affordable housing will reduce the number of affordable rental units produced by the program each year.

Given the heterogeneity of corporations investing in affordable housing and the range of shareholders, the significant differences in the price effects will result in many corporations and investors leaving the market as a result of the change, while other corporations and investors will find higher after-tax rates of return from Housing Credit investments. At the margin, corporate shareholders will earn the same return from Housing Credit investments as comparable alternative investments, but the price in the market for Housing Credit will be lower.