CBO TESTIMONY

Statement of
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before the
Subcommittee on Taxation
Committee on Finance
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Mr. Chairman and Members of the Subcommittee, I am pleased to have the opportunity to discuss S. 1787, a bill that would establish a tax credit for purchases of commercial property from the Resolution Trust Corporation (RTC). The Congressional Budget Office's (CBO's) analysis of this proposal reaches the following three conclusions:

- The credit would increase the resolution costs of the savings and loan debacle;

- The credit would not increase sales of RTC property; and

- The credit would not increase local commercial property values.

Let me begin with a brief description of the salient aspects of the proposed credit. It would apply to sales of RTC commercial property sold in 1992 and 1993. The total value of the credits would be capped at $1 billion. In each case, the RTC would set the value of the credit made available to the buyer to equal the minimum amount needed to sell the property. Under S. 1787, the present value of the credit cannot exceed 80 percent of the purchase price of the property plus necessary rehabilitation and completion costs. The buyer must use the tax credit in five equal annual installments, beginning with the year of purchase. The amount of the credit would not reduce the depreciable basis of the purchased property.

Moreover, the credit would be subject to limits on the amount that could reduce a taxpayer's total tax liability. For corporations, the credit generally could reduce total tax liability by no more than $25,000 plus 75 percent of the tax otherwise owed in excess of $25,000, under the rules covering general business credits. Credits that are limited in this way could be carried forward and used in future years. If the buyer subsequently sold the property, the buyer would pay 20 percent of any profits realized to the RTC, in addition to any capital gains taxes that would be due to the IRS.

ANALYZING THE PROPOSED CREDIT

CBO's analysis focuses on how the credit would affect the resolution cost of the savings and loan insolvencies as well as what its likely effect would be on sales of RTC property and on the value of commercial real estate. To examine these effects of the credit, one needs to specify the base case policy against which the credit should be compared.

CBO has concluded that the credit should be compared with the alternative of the RTG lowering the prices of the properties sufficiently to ensure that they are sold. This base case for comparison is different from the one used in the GRC Economics study, *Economic Implications of a Tax Credit Program to Facilitate the Sale of RTC Property.* That study compared the tax credit with a policy in which the RTC held onto the properties, trying to sell them at unrealistically high prices. Unfortunately, that study's analysis is flawed because such holding costs are avoidable under current law. The RTC currently has the authority to reduce prices directly in response to local market conditions, and it has in fact exercised this authority.

The Costs of Resolution

The tax credit would affect the timing and value of receipts to the Treasury and the RTC. The sales prices of properties sold with the credit would be higher than in the base case because the buyers would be willing to pay for the tax benefit. This higher amount of receipts would flow to the RTC immediately upon sale of the properties in 1992 and 1993. Because these receipts would be classified as offsetting collections in the federal budget, federal spending would decline immediately.

However, the cost of resolution must also take account of the revenue loss associated with the tax credits. Tax receipts would be reduced over the five years in which the credit would be distributed. In this way, the RTC's net outlays would be reduced quickly, but the Treasury would experience a long-term revenue loss. Because the effects of sales under the credit alternative would stretch over a five-year period while those of the base case would occur in a single year, it is appropriate to compare the costs of resolution under the two alternatives on a present value basis.

Under certain extreme circumstances, tax credits and lower prices could result in the same sales at the same cost to the government. This result would take place if a credit that costs the same as a lower price has the same value to potential buyers. A potential buyer would, for example, equally value a guaranteed tax credit with a present discounted value of one dollar and a one dollar reduction in the price of the property.

In practice, the alternatives are not equal because the buyers would take into account both the riskiness of the credits and the difference between their own discount rates and the federal government's. Both of these differences would make buyers require a premium of credits over direct price reduction. Several reasons account for this. First, buyers would bear much risk with this tax credit from unexpected changes in net income and tax law. For example, buyers might unexpectedly find themselves with no tax liability against which to use the credit, or they might be constrained by the limits on the use of the credit. In addition, the credit might be repealed before the buyers are able to use all of their credits five years down the road. Second, the buyers would have a higher discount rate than the federal government, since they face a higher cost of funds.

In addition, a limited pool of potential buyers under the credit alternative would contribute to a lower after-tax price paid by the buyer than in the base case. Since not all potential buyers would be able to take advantage of the proposed tax credit, the RTC's potential market for selling these properties would be restricted. Some potential buyers are nonprofit institutions that are exempt from the corporate tax, while others may be unprofitable and therefore unable to use the tax credit.

These factors lead to the conclusion that it would be more costly for the government to sell the properties with the credit than to sell them at a lower price without the credit. Use of the credit would increase the costs of resolving the insolvent savings and loans on a present-value basis, even after taking into account the higher immediate receipts by the RTC from the higher sales prices. In other words, the present value of the revenue loss from the credits would exceed the present value of the increase in RTC receipts. In this way, the tax credit would be similar in effect to the Federal Savings and Loan Insurance Corporation's use of tax benefits to finance pre-1989 resolutions of insolvent savings and loans.

The proposal's profit-sharing component does not alter this conclusion. Under the proposal, if the buyer resells the property, the RTC receives 20 percent of the realized gain on the property. The buyer would treat this profit-sharing arrangement no differently than the income tax on the gain from the sale of capital assets. The buyer would know that the potential return to the property would be reduced upon sale, and the buyer would incorporate this knowledge into the bid price for the property. If anything, the potential buyer would require even more tax credits as reimbursement for the tax on the return to risk.

Effects on Sales of RTC Property and Prices of Other Commercial Property

CBO concludes that the proposed credit would not increase sales of RTC property above the amount of sales in the base case. After all, any property that the RTC could sell with the credit could be sold as easily in the base case with an even smaller direct price reduction. The investors who make their money available to buy the property would surely understand the advantages of the direct price reduction over the credit. As a result, we would expect the availability of this tax credit not to spark any increase in buyers' interest in the RTC properties.

We also conclude that the proposed credit would not act to prop up local commercial property values because the underlying rental value of the properties would not be affected. The after-tax price that buyers would be willing to pay for a property depends on the after-tax cash flow and the discount rate. In turn, the after-tax cash flow depends on the rents that can be earned from the property. Because the underlying supply of properties would be unchanged, the tax credit would not affect the rents for both these RTC properties and other, competing properties. Thus, the credit would not affect the after-tax prices of the RTC properties and competing properties. The proposed credit would raise the price of only the affected RTC properties because the buyers would be willing to pay specifically for the tax subsidy. The credit would not change the prices of commercial properties in general, which would remain depressed from the overbuilding of the past decade--a development that is apparent in today's high commercial vacancy rate of nearly 20 percent.

Viewed in a different way, the credit would not affect potential buyers of competing commercial property because they would "see through" the higher nominal sales price on RTC properties that included a tax benefit. True, sale of RTC property with a credit would be recorded at a higher selling price. Potential buyers in the general real estate market would have no reason, however, to offer higher prices for properties that do not have the same associated tax benefit.

In summary, S. 1787 would be expected to increase the resolution costs of the savings and loan debacle on a present discounted basis without stimulating sales of RTC properties or improving conditions in the local real estate markets.