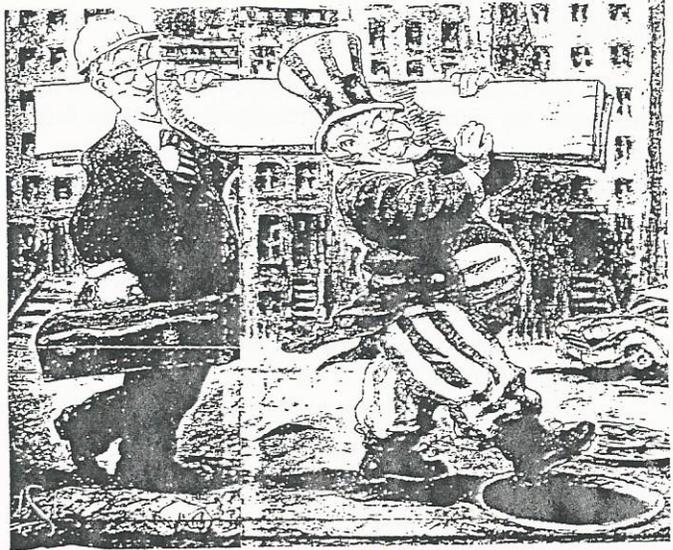


TRIPPING THE TAX MAN

Investments in tax credits that fund affordable housing can bolster the bottom line and polish a firm's reputation as a good corporate citizen



When Warren Buffett invested \$25 million in affordable housing tax credits three years ago, he was puzzled that more corporations weren't investing more money in the federally sponsored tax credit program used to finance the relatively illiquid market for low-to-moderate income housing. Calling it a perfect marriage of corporations and social causes, Buffett's Berkshire Hathaway reaped an annual return of 15 to 20 percent over a 10-year period in the form of tax credits created by the Federal Housing Tax Credit Program (part of the 1986 Tax Reform Act).

It's no surprise that corporations from virtually every industry, and even the government itself, have invested in these tax credits. The Federal National Mortgage Association (Fannie Mae) is one of the largest investors, to the tune of \$250 million. Companies such as Chevron, BankAmerica, United Airlines and international communications and printing giant R.R. Donnelley & Sons have taken the plunge. NationsBank Corp. made news earlier last year when it committed \$100 million to tax credit investments. San Diego Gas & Electric even formed a separate subsidiary to invest in these programs.

Besides providing financial benefits, tax credit investments also can be good PR. In fact, many banks that invest can earn additional bonus points under the Community Reinvestment Act.

OUTLINING THE PROGRAM

Administered by the U.S. Treasury Department, the tax credit program gives investors (individuals as well as corporations) significant tax benefits that translate into increased income in exchange for providing equity to help build affordable rental housing for the elderly and working citizens with moderate incomes. Almost all newly constructed affordable housing units in the past few years have been financed with the program, according to the National Council of State Housing Agencies.

Nationwide, the program has produced more than 600,000 units of affordable housing. The program itself is relatively straightforward. The federal government (under the watchful eye of the Treasury Department) allocates a finite amount of tax credits to each state on a per-capita basis (\$1.25 per person). Each state agency awards the tax credits to affordable housing properties based on strict federal guidelines, which include demonstrated need, economic viability of the property and experience and financial strength of the developer. The successful program had been extended annually since 1989, its original expiration year. Last year, Congress and President Clinton stopped fooling around and permanently extended the program as part of the Omnibus Budget Reconciliation Act.

Each year for 10 years, individual investors receive tax credits that directly reduce the taxes they owe on their last \$25,000 of income. That amounts to trimming as much as \$9,900 annually off their tax bills if they're in the new highest 39.6 percent tax bracket ($39.6 \times 25,000$); \$9,000 in the 36 percent tax bracket; \$7,750 in the 31 percent tax bracket; \$7,000 in the 28 percent tax bracket.

Entered on line 44 of the IRS Form 1040, tax credits are a direct, bottom-line reduction of federal income tax liability from all sources of income, including active income from wages and portfolio income from interest and dividends. Reducing tax liability increases after-tax spendable income. Every dollar of tax credit provides a dollar of additional cash to save, spend or invest.

UNLIMITED CORPORATE BENEFITS

But for most individual investors, there is an annual \$9,900 limit to the government's largess. Corporate investors have no such annual limitations. Widely held "C" corporations can use virtually an unlimited amount of tax credits to reduce federal income tax liabilities from all sources of income without exception, subject only to the general limitations on general business tax credits and the adjusted current earnings tax. (Tax credits do not cause ACE but cannot be used to reduce ACE, either.) There are some restrictions for closely held "C" corporations and "S" corporations.

In addition to the tax credits, the affordable housing investment also generates tax losses from depreciation and interest expense. That same \$1 million investment usually will generate about \$1 million in losses as well. For a corporation in the 40 percent tax bracket (state and federal), that means about \$400,000 in direct tax savings from the passive losses.

It is not unusual for these investments to generate some cash distributions (tax-deferred cash flow) starting about the sixth or seventh year. Besides the tax benefits, the underlying investment (real estate) can provide capital appreciation potential from the sale or refinancing of the properties.

BOLSTERING STOCK VALUE

What does this mean to a corporation's financial statement? Plenty. Tax credits directly reduce income tax expense, thus improving after-tax earnings. A direct reduction of tax liability increases a corporation's earning per share and positively affects stock value. For example, if a stock trades at a 10-to-1 price-earnings ratio, a \$1 million direct tax savings reflected in earnings per share can enhance stock value by \$10 million.

Also, a direct reduction of tax liability enhances after-tax cash flow and, ultimately, retained earnings, thus increasing corporate asset value. And since an investment in tax credits is funded with dollars that would otherwise be allocated to paying taxes, converting tax dollars into spendable cash increases working capital.

A qualifying property is allocated a full 10 years of tax credits up front, to be taken at a predetermined rate each year, resulting in a predictable, steady stream of benefits, provided the guidelines are followed. The guidelines are reasonable and achievable, and include the stipulation that 40 percent of the rental units be occupied by tenants with incomes 60 percent or less than the area median income.

The federal government accounts for the full 10-year tax credit benefit stream up front as well, effectively pre-funding and assuring the amount of tax credits available for each property throughout the credit period.

Originally, the 1986 Tax Reform Act created and funded the program for just three years. However, a federal program this successful does not go unnoticed in Washington. With the backing of virtually every member of Congress and all three administrations since 1986, annual extensions to the program were a foregone conclusion until finally a permanent extension was made last year.

The permanent extension ensures a continuous, uninterrupted source of new tax credits that can be used for new investment opportunities each year, without begging Congress for funds. Congress already has budgeted and accounted for the annual cost of these tax credits up front. This translates into about 125,000 units of new affordable housing properties that will be awarded tax credits this and every year.

The new 1993 tax law also increased corporate tax rates to 35 percent, a move that should only increase corporate interest in tax credit investments. (It did the same thing for individual investors by increasing the new highest tax brackets to 39.6 percent and 36 percent.)

Even with the permanent extension, funding the construction of only about 125,000 new affordable housing apartment units each year will in no way dent the extraordinary demand for this housing. The unmet demand for low-to-moderate income housing, by the government's own statistics, will continue unabated at about 4 million units. That's a 32-year backlog.

In addition to the tax credits, passive losses and socially responsible aspect of investing in affordable housing, there is also capital appreciation potential from the real estate itself. Once the tax credits have been exhausted, and the compliance period has expired, the properties usually are earmarked to be sold, refinanced or converted to market rate housing. At this point, investors generally expect to receive all or some of their original capital back, depending on the value of the property.

A study conducted by Robert Stanger, publisher of The Stanger Report (a rating service for limited partnerships), showed that of the 64 affordable housing properties his firm has tracked over the past 20 years, all of the properties gained in value from their original purchase prices. Investment in housing tax credits can be a win-win situation for corporations, consumers and the government. Amid the heated debate about economic "fairness," that stands as a remarkable achievement.