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Briefing Report to Congressional Requesters

November 1991

RESOLUTION TRUST CORPORATION

Proposed Tax Credit Would Add to Government's Cost of Selling RTC Assets

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The Honorable Donald W. Riegle, Jr.
Chairman, Committee on Banking, Housing
and Urban Affairs

The Honorable Jake Garn
Ranking Minority Member
Committee on Banking, Housing
and Urban Affairs

The Honorable John Breaux
United States Senate

This briefing report responds to your March 25, 1991, request that we review whether a tax credit would facilitate the sale of distressed property held by the Resolution Trust Corporation (RTC). Specifically, you asked us to evaluate the cost effectiveness of a tax credit program that would begin on January 1, 1992, and have a cap of $1 billion. You also asked us to discuss RTC's strategies to dispose of properties by lowering their prices and using other available alternatives.

The tax credit would be earned in 5 equal annual installments, and it would have a present value of up to 80 percent of the purchase price plus the cost of necessary rehabilitation of the applicable RTC property. Other specific characteristics of the tax credit proposal are listed in appendix I.

BACKGROUND

RTC was established on August 9, 1989, under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). RTC's overall mission is to resolve the problems of institutions previously insured by the Federal Savings and Loan Insurance Corporation and placed into conservatorship or receivership between January 1, 1989, and August 9, 1992. As of June 30, 1991, RTC had 193 depository institutions in conservatorship with gross assets having a book value of $89 billion. Also under RTC's jurisdiction were 430 receiverships with $71 billion in assets.

RESULTS IN BRIEF

We found that the Federal government would lose about $127 million on a present value basis with the proposed $1 billion tax credit program. Although the tax credit would increase sales revenue to RTC, these gains would be exceeded by the lost revenues to the Treasury. This result was obtained by comparing the proposed tax credit with RTC's current policy of obtaining sales by pricing real estate assets according to market values.

A private study of the tax credit proposal arrived at a different conclusion. This study concluded that the proposed RTC tax credit would have a benefit-to-cost ratio for the federal government of almost 2 to 1 when compared to the alternative of holding property in inventory for 5 years for eventual sale. This alternative, however, is not a realistic basis on which to analyze the tax credit because RTC's current policy is to sell properties soon after acquisition by setting price to market value.

RTC has several programs in place to dispose of its real estate properties. These include reducing prices to reflect current market values and providing seller financing. We are still reviewing the performance of these programs. In March 1991, RTC approved a new guideline giving its officials more flexibility in setting prices for properties to reflect market values.

Overall, we do not believe that this tax credit proposal is a cost-effective way for RTC to dispose of its commercial real estate assets. However, if Congress decides to enact this program, we suggest several changes be made to the original proposal to help minimize the losses. Two changes need to be made to align the RTC credit with the low income housing tax credit to avoid distortions in investor choices: the tax credit should be reduced from 80 percent to 30 percent of the present value of the purchase price and the number of years to claim the tax credit should be increased from 5 years to 10 years. Other changes would need to be made to protect RTC's financial interest. The tax credit proposal should provide for full recapture of the tax credits and penalties if RTC forecloses properties previously sold with tax credits attached to them. The proposal should also limit the fees that the syndicators would be able to receive from the sale of tax credit participations to private investors.

OBJECTIVES, SCOPE, AND METHODOLOGY

Our objectives were to

-- determine the net fiscal impact of the tax credit proposal described in your letter,

-- describe strategies used by RTC to dispose of properties by lowering their prices and using other available alternatives, and

-- discuss ways to improve the tax credit proposal.

To address these objectives, we used present value analysis to measure the benefits and costs of the tax credit program that would occur over 5 years. In addition, we interviewed various private sector representatives and consultants knowledgeable of the real estate industry, including an official of the private firm that prepared an economic analysis of the tax credit proposal. We also interviewed an RTC official responsible for sales of real estate assets, and we examined RTC data and RTC directives on real estate assets sales. We did not assess the reliability of RTC data because of time constraints. We reviewed previous congressional testimonies of RTC officials as well as GAO reports and testimonies on RTC.

We did our work in Washington, D.C., between June 1991 and September 1991 in accordance with generally accepted government auditing standards.

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We discussed the contents of this report with an RTC official responsible for real estate operations, who generally agreed with the analysis and information provided. His views have been incorporated into this report where appropriate.

We are sending copies of the report to the Secretary of the Treasury, the Chairman of the Federal Deposit Insurance Corporation, the Chairman of the Oversight Board of the Resolution Trust Corporation, the Executive Director of the Resolution Trust Corporation, the Director of the Office of Thrift Supervision, the Director of the Office of Management and Budget, and other interested parties. We will also make copies available to others upon request.

The major contributors to this report are listed in appendix II. If you have any questions, please contact me at (202) 272-7904.

Paul L. Posner

Paul L. Posner
Associate Director, Tax Policy
and Administration Issues

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ABBREVIATIONS

AMT	Alternative Minimum Tax
FDIC	Federal Deposit Insurance Corporation
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act of 1989
RTC	Resolution Trust Corporation

THE RTC TAX CREDIT PROPOSAL:
DESCRIPTION, ANALYSIS, AND SUGGESTIONS

Characteristics of the RTC Tax Credit Proposal

- January 1, 1992 start.
- $1 billion cap.
- 80 percent present value maximum of purchase.
- Credits provided in five annual installments.
- Many other characteristics.

CHARACTERISTICS OF THE RTC TAX CREDIT PROPOSAL

We were asked to evaluate the feasibility of a Resolution Trust Corporation (RTC) and Federal Deposit Insurance Corporation (FDIC) tax credit with the following characteristics: (1) it would begin on January 1, 1992, (2) it would not apply to property purchased from RTC or FDIC after December 31, 1993, unless pursuant to an earlier binding contract, (3) the credit program would have a $1 billion cap on tax credits during the 2-year period, (4) the tax credit would have a present value of up to 80 percent of the purchase price plus the cost of necessary rehabilitation and completion for the acquisition of RTC and FDIC property, (5) the amount of the credit would be determined by RTC or FDIC and could not exceed the amount determined to be necessary to sell the property and could not exceed the amount of capital contributed by the purchaser of the property, (6) the credit period would be for 5 years beginning with the taxable year in which the property is purchased and would be earned in 5 equal installments, (7) any capital raised from investors using this credit would be paid directly to RTC and FDIC, (8) the credits from this program could be used to offset the lesser of $50,000 or 50 percent of the tax liability on non-passive income for individuals, (9) for corporations, the credit would be subject to the rules of the general business credit, including the maximum amount of income tax liability that may be reduced by a general business credit for any year, (10) the credit would not be considered as a preference item under the Alternative Minimum Tax (AMT) and could be used to offset tax due and owed under an AMT calculation subject to the limitations described above, (11) upon the sale of the property, 20 percent of any profits would be paid directly back to RTC and FDIC with the remaining profits being taxed at the appropriate capital gains rate, (12) ownership of property purchased by a private taxpayer under the credit must be maintained for 5 years in order for the taxpayer to continue to receive the credit, and (13) sale or refinancing of property before the end of the credit period would not trigger recapture but would cause any future tax benefits to cease.

Objectives

- To examine the net fiscal impact of the tax credit proposal.
- To describe RTC's strategies for disposing of properties without using tax incentives.
- To suggest improvements to the tax credit proposal.

OBJECTIVES

We were asked to examine the net fiscal impact of the tax credit proposal. We were also asked to describe strategies employed by RTC and FDIC to dispose of properties without tax incentives including lowering the price of the property and other available alternatives. In addition, we were asked for suggestions on how the tax credit proposal could be made more effective.

Methodology

- Present value analysis.
- Interviews with private sector representatives and consultants and with RTC official.

METHODOLOGY

We used present value analysis to measure the benefits and costs of the tax credit program over 5 years. Present value analysis is used to measure the net impact of programs whose benefits and costs would occur over different time periods.

In addition, we interviewed various private sector representatives and consultants knowledgeable of the real estate industry, including an official of the private firm that prepared an economic analysis of the tax credit proposal.

We also interviewed an RTC management official responsible for the sales of real estate assets, and we examined RTC data and directives on real estate asset sales. We did not assess the reliability of RTC data because of time constraints.

We reviewed previous congressional testimonies of RTC officials as well as GAO reports and testimonies on RTC.

Fiscal Impact of the Tax Credit

Net RTC gain minus Treasury loss in net present value terms.

Treasury loss estimate exceeds net RTC gain by $127 million.

Transaction costs will decrease RTC gain.

FISCAL IMPACT OF THE TAX CREDIT

Most analysts would agree that the RTC tax credit would affect the federal government chiefly in two ways: (1) the U.S. Treasury would lose tax revenues over the 5 years that investors claim tax credits,[1] and (2) RTC would gain additional sales revenue from higher prices due to the tax credit.

Comparing these two effects over time using present value analysis, we estimated that the Federal government would lose $127 million due to the RTC tax credit program. We subtracted the present value of the Treasury tax revenue losses from the present value of the net additional revenues that RTC would obtain through the sale of tax-advantaged properties.

The Treasury's loss will exceed RTC's net gain because Treasury's discount rate is lower than private investors' discount rate, and positive transaction costs involved with the marketing of tax credits would reduce RTC's net sales revenues. The size of the loss will vary with changes in discount rates and transaction costs.

We did not include savings in holding costs as a benefit of the tax credit proposal because we concluded that the relevant alternative to the tax credit is lowering the price of RTC real estate assets to achieve quicker sales.

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[1]Due to time constraints, we did not include in the analysis estimates of (1) the administrative costs of the tax credit program, or (2) the tax revenue losses that would occur because purchasers of subsidized RTC properties would be entitled to offset depreciation expenses against ordinary income with respect to the entire purchase price of the properties.

Fiscal Impact of the Tax Credit

Table I.1: Estimates of the Present Value of Treasury's Tax Revenue Losses Due to the RTC Tax Credit (Dollars in millions)

Year	Nominal value	U.S. Treasury's discount rate 7%	8%	9%
1	-$200	-$187	-$185	-$184
2	-$200	-$175	-$171	-$168
3	-$200	-$163	-$159	-$154
4	-$200	-$153	-$147	-$142
5	-$200	-$143	-$136	-$130
Present value		-$820	-$799	-$778

Note: Sum of annual amounts may not be equal to present value due to rounding.

TREASURY'S TAX REVENUE LOSSES

We estimated the present value of the tax revenue losses to the Treasury by discounting them by an appropriate government discount rate that reflects Treasury's borrowing costs. We discounted the 5 annual $200 million tax revenue losses by a discount rate of 8 percent. Then we added the 5 annual discounted values to obtain the total present value of the $1 billion in tax revenue losses. The present value of Treasury's tax revenue losses is about $799 million if the applicable discount rate is 8 percent.

GAO's policy is that the government's discount rate should be the interest rate for marketable Treasury debt with maturity comparable to the program being evaluated, which in this case would be 5 years.[2] We assumed that the government's discount rate would be 8 percent, which is close to the 8.37 percent annual average rate for 5-year Treasury notes in 1990. GAO's policy is also to use a sensitivity analysis to address issues of different interest rates and opportunity costs faced by private investors. We also estimated Treasury's tax revenue losses using a 7-percent and a 9-percent discount rate.

As shown in Table I.1, if the discount rate decreases to 7 percent, the present value of Treasury's tax revenue losses increases to $820 million. If the government's discount rate increases to 9 percent, the present value of the tax revenue losses will decrease to $778 million.

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[2]Discount Rate Policy (GAO/OCE-17.1.1, May 1991).

Fiscal Impact of the Tax Credit

RTC's gain--investors' valuation of the tax credits.

- $721 million additional sales revenue for RTC properties assuming 12-percent investors' discount rate.
- Transaction costs reduce RTC gain by $49 million.

RTC'S GAIN DEPENDS UPON INVESTORS' VALUATION OF TAX CREDITS AND TRANSACTION COSTS

RTC properties with a $1 billion tax credit attached to them should have a higher value to private investors than similar properties without the tax advantage. The $1 billion in tax credits, which would be distributed in 5 equal annual installments of $200 million, represents 80 percent of $1.25 billion worth of properties that investors would have to purchase from RTC. The additional amount in sales revenues that RTC would obtain from attaching $1 billion worth of tax credits to its real estate assets would depend on the investors' discount rates and transactions costs.

Investors' Discount Rate

The additional amount that investors would be willing to pay to RTC for tax-advantaged properties depends on their discount rate. The discount rate compensates investors for deferring consumption spending and for bearing risks. The discount rate includes a risk premium that compensates investors for the likelihood of future negative events, such as (1) new legislation restricting the use of tax credits, (2) sale of tax-advantaged properties within 5 years of the purchase date, and (3) lack of taxable income to fully use the tax credit in any given year.

In order to find an appropriate discount rate for investors, we reviewed interest rate statistics published by the Federal Reserve Board, examined the real estate investment literature, and interviewed real estate consultants about the appropriate discount rate applicable to tax-advantaged real estate investments. We found that a 12-percent discount rate is an appropriate rate to be used in valuing private real estate investments involving tax credits.

If investors have a discount rate of 12 percent, the present value of the $1 billion tax credit to the investors will be about $721 million. Thus, investors would be willing to pay $721 million more for RTC properties with a $1 billion tax credit attached to them than for the same properties without the credit.

As with our analysis of Treasury's revenue losses, we did a sensitivity analysis to determine how these results would change if investors had different discount rates. Investors' discount rates are higher than Treasury's, reflecting private investors' higher borrowing costs. Accordingly, the present value of the revenues lost to the Treasury will exceed the present value of the tax credit and RTC's gains. RTC's gains would be further eroded due to transaction costs.

Fiscal Impact of the Tax Credit

Table I.2: Present Value of Tax Credits to Investors, Transactions Costs, and RTC Proceeds From Tax Credit Program (Dollars in millions)

Year	Nominal value	Investors' discount rate 10%	12%	15%
1	$200	$182	$179	$174
2	$200	$165	$159	$151
3	$200	$150	$142	$132
4	$200	$137	$127	$114
5	$200	$124	$114	$99
Present value of tax credits to investors		$758	$721	$670
Less: Transaction costs		($49)	($49)	($49)
Net proceeds to RTC		$709	$672	$621

Transaction Costs Reduce Gains From RTC's Sales

In general, transaction costs and management fees associated with investors' purchases of RTC properties would be subtracted from gross sales to obtain RTC's net sales revenues. As with the low income housing tax credit, investment partnerships might be formed to market the RTC tax credits to the public. The sale of RTC tax credits by investment partnerships would entail additional transaction costs to compensate the general partner and affiliates for organization and offering costs (including commissions). In a previous report on tax credits, we found that front-end costs ranged from 17 percent to almost 34 percent of equity in partnerships being marketed for low income housing tax credit projects.[3] We also found that the average equity of low-income housing tax credit partnerships was 23 percent of project costs.

We estimate additional transaction costs associated with marketing RTC tax credits would be $49 million. We assumed that equity would comprise 23 percent of $1.25 billion, as we found for the low income housing tax credit. We also made the conservative assumption that the syndication costs of the RTC tax credit program would be 17 percent of the equity of individual investors--the low end of the range for low income housing partnerships--and that they would be subtracted from the cash proceeds received by RTC.

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[3]Tax Policy: Costs Associated With Low Income Housing Tax Credit Partnerships (GAO/GGD-89-100FS, July 10, 1989).

Fiscal Impact of the Tax Credit

The role of holding costs

- A private study assumed quicker sales of RTC property with a tax credit saves holding costs.

- Quicker sales with a price reduction also saves holding costs.

THE ROLE OF HOLDING COSTS

Proponents of the RTC tax credit claim that one of its major benefits would be the savings in holding costs achieved by quicker sales of tax-advantaged properties. A private study that proposed the tax credit[4] concluded that the "benefit of selling RTC property with the RTC credit is almost 2:1 compared with the alternative of holding property for sale at a later date." This study assumed that RTC would have to wait 5 years to obtain the current asking price. The private study also assumed that RTC's annual holding costs were 9 percent of the book value of its properties and that RTC properties were subject to a 3-percent annual economic depreciation rate. These assumptions allowed the tax revenue losses caused by the tax credit to more than offset the burden of high holding costs, such as repair, maintenance, lost taxes, insurance, and economic depreciation.[5]

Because RTC's practice is to lower prices to achieve quicker sales, the RTC tax credit proposal is compared in our analysis to a price reduction, rather than holding properties in inventory. Thus, our estimate that the federal government would lose $127 million with the RTC tax credit program does not include the savings in holding costs because these savings would also be achieved if RTC sells its real estate assets more quickly by reducing prices.

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[4]GRC Economics, Economic Implications of a Tax Credit Program to Facilitate the Sale of RTC Property, September 1990.

[5]An RTC official testified on October 22, 1991, that the value of real estate under RTC control was $22.9 billion, and that the costs of maintaining that property amounted to $420 million over the period from January through August 1991. If we assume that the average balance of RTC's real estate assets in 1991 would be $22.9 billion, and maintenance costs would be incurred at the pace up to August 1991, then the ratio of maintenance costs to asset value would be 2.75 percent on an annualized basis. We did not review RTC's figures.

RTC's Past Pricing Practices

RTC's practice in setting prices inhibited asset sales by limiting ability to lower price to reflect market values

RTC'S PAST PRICING PRACTICES

We reported in previous congressional testimonies that the sale of distressed real estate assets had been much more difficult than most people had expected. From inception to March 31, 1991, RTC had taken control of real estate assets valued at about $23 billion. As of March 31, it had disposed of about $4.5 billion or 20 percent.[6]

RTC's past pricing practices inhibited faster disposition of its properties. RTC used appraised value as market value for the properties. RTC's practices prior to March 1991 were to allow sales of real estate for 95 percent of appraised value if the property was located in any of six "distressed" states. For all other states, the threshold was 90 percent of appraised value. Since most of the inventory was in distressed states, sales were generally restricted to a 5 percent variance until 6 months of marketing had occurred. After 6 months, RTC could accept 85 percent of appraised value and, after another 3 months, prices could be dropped another 5 percent.

According to RTC, its pricing directive was a hindrance to moving properties out of inventory at a higher rate because: (1) it assumed a high degree of accuracy and reliability in appraisals that it later found did not exist for many of its properties; (2) with only a 5 percent variance in prices permitted under the regulations, RTC was doomed to hold many properties for at least the initial 6 months; and (3) in declining markets, appraisal values were lagging behind real market values, making sales difficult with RTC's restrictive guidelines.

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[6]Resolution Trust Corporation: Update on Funding and Performance (GAO/T-GGD-91-43, June 11, 1991).

RTC Current Strategies for Disposing of Properties

Current RTC pricing practice.

- More flexibility to adjust sales prices to reflect market values.
- RTC offers seller financing.

RTC'S CURRENT STRATEGIES FOR DISPOSING OF PROPERTIES

Changes in Pricing Guidelines

In March 1991, the pricing guidelines were changed to permit RTC to adjust the price of distressed real estate to better reflect true market values, thereby expediting property sales. RTC approved new guidelines that allow RTC officials to sell properties at 80 percent of appraised value within 6 months of marketing, at 60 percent within 6 to 18 months, and at 50 percent within 18 to 24 months. Also, new appraisals would be required for properties still unsold after 2 years, with the appraiser fully advised of RTC's previous marketing efforts and pricing patterns. This change is too recent to determine whether it has met the expectations of RTC management.

RTC's Own Financing Program

RTC has begun a policy of seller financing for real estate assets in its receiverships. According to RTC guidelines, this financing would take the form, primarily, of fixed rate first mortgages requiring a 15 percent minimum down payment. The term of the loan would normally be 3 to 7 years with an interest rate determined by RTC field offices on a case-by-case basis under guidelines established by RTC regional offices. RTC has also offered more flexible financing in the form of cash flow participation mortgages where loan payments are tied to the property's performance. We have been monitoring this area and will report the results of our review of the cash flow financing under the portfolio sales program in the future.

Suggestions for Improving the RTC Tax Credit

- Reduce tax credit from 80 percent to 30 percent.
- Increase the number of years to claim the credit from 5 years to 10 years.
- Provide for the recapture of tax credits and penalties.
- Establish limits on transaction costs.

SUGGESTIONS FOR IMPROVING THE RTC TAX CREDIT

We were asked to provide suggestions to improve the tax credit proposal if Congress decides to enact the RTC tax credit.

Reduce Tax Credit From 80 Percent to 30 Percent of Purchase Price

The RTC tax credit proposal would allow investors to claim up to 80 percent of the purchase price plus present value of rehabilitation costs. This provision would make the RTC tax credit more attractive than the low-income housing tax credit, which is limited to the present value of 30 percent of the qualified basis of a new building that receives a federal financing subsidy. Reducing the tax credit from 80 to 30 percent of the purchase price would put the low-income housing tax credit and the RTC tax credit on a more equal footing and would allow RTC to attach the tax credit to $3.3 billion worth of properties, instead of $1.25 billion. However, the additional gain in RTC sale revenues will be the same because the offering price for each property will also be reduced.

Increase the Number of Years to Claim the Tax Credit From 5 to 10 Years

The RTC tax credit proposal would allow investors to claim fully the tax credit in 5 years. This provision would make the RTC tax credit more attractive than the low-income housing tax credit, which is generally claimed for 10 years. Extending the tax credit claim period from 5 years to 10 years would put the low-income housing tax credit and the RTC tax credit on a more equal footing, thereby minimizing distortions in investors' choices.

Recapture of Tax Credits and Penalties

If private investors were allowed to combine RTC's own financing and RTC tax credits, and investors do not meet the repayment terms of RTC's own financing, then there is a possibility that tax-advantaged properties may have to be foreclosed by RTC. We suggest that heavy penalties and full recapture of the tax credits be imposed on investors who purchase any tax-advantaged RTC property that is foreclosed by RTC in the future.

Establish Limits on Transactions Costs

Transactions costs such as developers' fees, syndication fees, legal costs, and management contracts would absorb a percentage of the cash payments from investors to RTC and/or increase the cash outlays required from investors. Congress could either include a definition of allowable costs or, alternatively, put a cap on total transactions costs to prevent excessive fees.

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