BOB DOLE
KANSAS

United States Senate
OFFICE OF THE MAJORITY LEADER
WASHINGTON, DC 20510

May 16, 1985

TO: Senator Dole

FROM: George Pieler

SUBJECT: Talk to National Association of Home Builders

You are scheduled to talk to the Home Builders at 9:00 a.m. Friday, May 17, at Rayburn rooms B338-340. They are mainly interested in your role as majority leader, the budget, and tax reform. Materials are attached, including discussion of real estate issues in tax reform.

Attachments

REAL ESTATE TAX REFORM ISSUES

A. Indexing Interest

The original Treasury proposal would allow a deduction only for "real" interest paid (i.e., the excess interest over the inflation rate). Similarly, the proposal would limit interest income to the excess over inflation. The proposal would require taxpayers to net interest earned and interest paid and apply a fraction to this amount which is intended to take inflation out. However, Treasury would leave present law for mortgage interst paid on a principal residence and for up to $5000 of other net interest expense incurred by an individual.

Obviously, the interest paid deduction is very important to real estate syndicators who are seeking investors in debt-financed projects. Also, limiting the amount of interst deductions for vacation homes to real interest would have an effect on that market. Most reports indicate that Treasury will drop this provision in their revised proposal.

B. Taxing Large Limited Partnerships As Corporations

The proposal would treat limited partnerships with more than 35 limited partners as corporations. This would mean that the partnership could not pass through deductions to partners. The reason for the 35 partner rule is that Subchapter S corporations which are not subject to a corporate level tax may not have more than 35 shareholders.

Publicly-offered real estate syndications would probably end if this proposal were adopted because they depend so heavily on passing through interest paid and depreciation deductions to the partners. The major problem with the proposal is that it would cause a discrimination between larger investors who can keep under the 35 partner rule and smaller investors who cannot afford a big enough investment to invest in a syndication with no more than 35 partners. Obviously, it will also have a greater impact on large syndications, whether they are publicly offered or not.

The Finance Committee Subchapter C report had a less restrictive rule treating limited partnerships as corporations only if the partnership interests themselves were publicly traded like stock in a major corporation.

C. Elimination of the "At Risk" Exception for Real Estate.

Generally, the total amount of deductions which a taxpayer may take with respect to an investment is limited to the amount he has invested, including debt on which he is personally liable.

However, investors in real estate (and certain equipment leases) may also take deductions equal to their share of debt on which they are not personally liable ("nonrecourse" debt).

The Treasury proposal would make the at risk limitation apply to all investments, including real estate.

The at risk exception allows real estate investors a substantial benefit which is not available to other investors. It is difficult to justify and is a testament to the political power of the real estate industry in past years. As you may recall, the Moynihan minimum tax proposal in 1984 would have effectively repealed the at risk exception for minimum tax purposes. The Finance Committee decided to extend the ACRS recovery period for real estate instead.

Imputed Interest

In addition to basic tax reform, the real estate industry is concerned about the imputed interest and original issue discount rules enacted last year.

The Realtors have endorsed a proposal, introduced by Senator Durenberger, which is even more generous than the 6 month temporary legislation which Congress passed late last year.

Essentially, the 6-month legislation allowed prior law for transactions where debt did not exceed $2 million.

Why the Deficit Matters

- Sustained deficits in the $200 billion+ range are a direct threat of the economy, because they will lead to either higher inflation or stagnation with rising unemployment. Cutting the deficit is the key to creating lasting jobs and restoring our position in international trade.

- The worst risk is that endless deficits will compound themselves: each year that we add $200 billion in new Federal debt adds about $15 billion to the next year's interest costs. The exploding cost of servicing the debt makes controlling spending that much more difficult.

- Endless deficits means higher interest rates--make it more difficult for people to own a home, borrow for their children's education, and plan for the future.

White House-Senate Budget Plan

- This is a very tough, very serious budget--no one understimates the difficulty of getting it passed. But it also is a balanced, reasonable package that calls on everyone--and every sector with a stake in the Federal budget--to give a little, to do with less Federal largesse than they would otherwise get.

- To demonstrate how serious this budget is: 13 programs would be eliminated. Defense would be held to an inflation increase in 1986 and to a 3% increase in each of the following two years: much less than the President wanted. And permanent savings would be achieved in all inflation-adjusted, non-means tested entitlement programs by freezing the COLA for the next year.

- In addition, to help lower-income Americans, SSI recipients would get both a full COLA and a $10 per individual/$15 per couple increase.

- All Federal pay, civilian and military, would be frozen for one year.

- The plan meets our goal of reducing the deficit to 2% of GNP by 1988, with reductions totalling about $295 billion over three years.

- This program goes beyond a freeze simply because a freeze is not enough to do the job. A freeze would not address the problem of long-term growth in spending and deficits, which is the key to eliminating fears about the stability of our recovery. In addition, a freeze just postpones making the policy decisions--in terms of priorities among spending program--that have to be made if we are serious about the deficit problem.

- Over the past three years deficits have totalled $606 billion: an average of 5.7% of GNP. That is just not sustainable if we want to continue a strong economic recovery.

- If we do nothing, the situation gets much worse, even under optimistic projections: $716 billion in additional deficits over the next three years.

- Under the compromise Deficit Reduction Plan, Federal borrowing as a percent of private savings would decline from an estimated 78% this year to 30% by 1988. That will dramatically reduce pressure on credit markets due to Treasury borrowing--free available capital for private investment and job creation--reduce interest rates, and help our trade position.

- Even with this budget plan, we will still be spending an enormous amount to meet the basic needs of our citizens. Nondefense spending still will increase each year, from $520 billion in 1984 to $583 billion in 1988. Similarly, combined Medicare and Social Security spending will continue to rise--from $232 billion in 1984 and $293 billion in 1988: nearly 7 times the amount that wao spent on those programs in 1970.

- Means-tested safety net programs are kept intact and will continue to grow as scheduled under present law. By 1988, safety net spending will still exceed the 1980 level by 72%.

- Agricultural programs will undergo major reforms, but by 1988 we will still be spending between $13 billion and $15 billion a year--much higher than any year before 1980. And don't forget that over the past three years we spent a record $53 billion on farm programs, while largely doing the agricultural economy more harm than good.

FINAL SENATE BUDGET

PROGRAMS TERMINATED (13)

- o Trade adjustment assistance to firms
- o Conrail (Sale)
- o Appalachian Development Program
- o Economic Development Administration
- o UDAG
- o General Revenue Sharing
- o Export-Import Bank Direct Loans
- o Community Services Block Grant after 1986
- o WIN
- o HODAG
- o Section 312 Rehabilitation Loans
- o U.S. Travel and Tourism Program
- o Direct Treasury Payment for most of Postal Subsidy Program

MAJOR ADJUSTMENTS TO ORIGINAL WHITE HOUSE/LEADERSHIP (WH/L) PLAN (DOLE PACKAGE)

- o Medicare/Medicaid: reduces 3-year savings from $20.1 billion to $17.5 billion
  - No cap on state medicaid reimbursement
  - No Part B premium increase in 1986. Phased up to 30% over next five years vs. 35% in WH/L plan.
- o AMTRAK: 12%/25%/40% cut instead of termination
- o SBA: $2.5 billion 3 year savings compromise instead of total termination of lending programs ($5.0 billion savings)

- Mass Transit Operating Subsidy: 20% cut instead of 5-year phase out

- Impact Aid Part B: Freeze at 1984 level ($78 million) instead of termination

- Postal Subsidies: Small newspapers and non-profits retain subsidized rates. Substantive legislation to limit program abuses, improve overhead allocations and spread part of subsidy cost over all regular rate users.

- Agricultural Programs: $3.5 billion added back to WH/L plan plus following programs:

  - New export incentive program using CCC stocks to counter foreign subsidies

  - New farm credit interest rate buy-down program

  - $1 billion per year add on for farm credit guarantees

  - No change in Federal crop insurance

  - Soil and water conservation cut reduced from 30% to 15%

  - Compromise on REA

- Job Corps: 30% cut instead of termination

- Student Aid: Freeze on student assistance at 1985 level and $200 million savings in GSL programs. No $8,000 cap on cost of education (Stafford compromise)

- NIH Grants: 6,000 new research grants per year vs. 5500 in WH/L

KEY POINTS ON SENATE BUDGET

- Through spending cuts alone, the plan would reduce the deficit by $56 billion in FY 1986, and about $295 billion through FY 1988.

- Cuts of this magnitude leave remaining deficits of $171 billion in FY 1986, $145 billion in FY 1987, and $104 billion in FY 1988.

- This plan reaches the goal we set of getting the deficit down to 2% of GNP by 1988, without tax increases.

- Every area of the budget is hit hard: the President's defense request is cut to zero in 1986, 13 programs are terminated, and permanent entitlement savings are achieved by freezing all non-means tested COLAs for one year.

- These are real, meaningful cuts and should have a significant impact on financial markets. Results from a survey of leading Wall Street financial advisers indicates that we should expect interest rates to drop by 1 or 2 percentage points in the near term and by as much as 3 points in 1988 if we follow through this package.

- If that happens and keeps the recovery on track, we can expect:

  - almost 7 million new jobs by 1988
  - housing starts back up to the 2 million units/year level
  - inflation staying down at 4% or less
  - national personal income up by $800 billion by 1988
  - potential increase of 18-26% in net income for small business (due to lower interest rates)
  - a potential increase of $2-4 billion in net farm income (due to lower interest rates)