

SPECIAL TAX ALERT: HOUSING ASSISTANCE ACT OF 2008

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OVERVIEW

On July 30, 2008, the President signed into law the *American Housing Rescue and Foreclosure Prevention Act of 2008*,¹ designed to help the housing market and reform lending practices. Included in that Act is the *Housing Assistance Tax Act of 2008*,² which provides some tax breaks for new home buyers and current home owners, as well as brings changes to the **REIT rules**, the **low-income housing tax credit**, the **tax-exempt bond requirements**, and **other technical tax changes**. This Alert will summarize the more significant tax changes in the *Housing Assistance Tax Act*, including the changes to the exclusion of gain on sale of a principal residence.

§ STA.01 Credit for First-Time Home Buyers

The *Housing Assistance Tax Act* provides for a refundable tax credit equal to the lesser of \$7,500 (\$3,750 for married individuals filing separately) or 10 percent of the purchase price of a principal residence.³ The credit is allowed for the tax year in which the taxpayer purchases the home. The credit phases out for taxpayers with modified adjusted gross income between \$75,000 and \$95,000 (\$150,000 to \$170,000 for joint returns),⁴ and is not available for purchases from a related party.⁵ A taxpayer is considered a first-time home buyer if the individual (and the individual's spouse) had no ownership interest in a principal residence during the three-year period prior to the date of purchase of the home.⁶ However, a taxpayer will not be entitled to the credit if (1) the taxpayer was entitled to the Washington D.C. homebuyer credit for any prior year;⁷ (2) the taxpayer's home financing is from tax-exempt mortgage revenue bonds;⁸

¹ H.R. 3221, P.L. 110-289.

² Division C of H.R. 3221, Sec 3000(a).

³ I.R.C. § 36(a), (b); H.R. 3221 Sec. 3011.

⁴ I.R.C. § 36(b)(2).

⁵ I.R.C. § 36(c)(3)(A)(i).

⁶ I.R.C. § 36(c)(1). The term "principal residence" has the same meaning as in I.R.C. § 121.

⁷ I.R.C. § 36(d)(1), referring to the credit in I.R.C. § 1400C.

⁸ I.R.C. § 36(d)(2).

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(3) the taxpayer is a non-resident alien;⁹ or (4) the taxpayer disposes of the residence (or it ceases to be the taxpayer's principal residence) before the close of the tax year for which the credit otherwise would be allowable.¹⁰

The credit is recaptured ratably, with no interest charge, over 15 years, beginning in the second taxable year after the year in which the home is purchased.¹¹ Thus, the credit is more like an interest-free loan from the government to the taxpayer. For example, if the taxpayer purchases the home in 2008, and a \$7,500 credit is allowable on the 2008 return, annual repayments of \$500 per year for 15 years [$\$7,500 / 15$ years, or $6 \frac{2}{3}$ percent of the credit] begin with the 2010 return. If the taxpayer sells the home (or ceases to use the property as a principal residence), prior to complete repayment of the credit, any remaining repayment amount is due on the tax return for the year in which the home is sold (or is no longer used as a principal residence).¹² There are exceptions to this recapture payment upon certain events, such as death, certain involuntary conversions, transfers between spouses or incident to divorce, and where gain on sale does not exceed the recapture amount.¹³

The provision applies to a principal residence purchased by the taxpayer on or after April 9, 2008 and before July 1, 2009.¹⁴ In addition, a taxpayer purchasing a home during the eligible period in 2009 can elect to treat the purchase as if it occurred on December 31, 2008 for purposes of taking the credit on their 2008 return.¹⁵

§ STA.02 Property Tax Deduction for Non-Itemizers

The *Housing Assistance Tax Act* creates a new standard deduction for state and local real property taxes.¹⁶ Prior to this Act, a taxpayer had to itemize deductions, rather than take a standard deduction, in order to deduct property taxes. Note that the standard deduction for the 2008 tax year is \$ 5,450 for unmarried taxpayers and \$10,900 for joint returns.¹⁷ Thus, taxpayers would itemize their deductions when the total of all itemized deductions exceeded these amounts.

The *Housing Assistance Tax Act* allows a "real property tax deduction" for non-itemizers in addition to the standard deduction amount indicated above.¹⁸ Taxpayers can deduct up to \$500 for single taxpayers (\$1,000 for joint returns) for real

⁹ I.R.C. § 36(d)(3).

¹⁰ I.R.C. § 36(d)(4).

¹¹ I.R.C. § 36(f).

¹² I.R.C. § 36(f)(2).

¹³ I.R.C. § 36(f)(3) & (4).

¹⁴ I.R.C. § 36(h). If a home is being constructed, it will be considered as purchased on the date that the taxpayer first occupies the residence. I.R.C. § 36(c)(3)(B).

¹⁵ I.R.C. § 36(g).

¹⁶ H.R. 3221, Sec. 3012, amending I.R.C. § 63.

¹⁷ Rev. Proc. 2007-66, 2007-45 I.R.B. 970.

¹⁸ I.R.C. § 63(c)(1)(C).

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property taxes paid.¹⁹

The usefulness of this provision is quite limited. The deduction is currently available only for the 2008 tax year.²⁰ In addition, most taxpayers with a home mortgage will have enough itemized deductions from home mortgage interest and property taxes to justify itemizing their deductions rather than taking the standard deduction.

Thus, this new provision will mainly benefit those homeowners who have no mortgage on their home. Moreover, unlike the first-time home buyers' credit discussed above, which is a refundable tax credit, the property tax is a deduction, meaning that the actual economic benefit to the taxpayer depends on the taxpayer's tax bracket. For example, a \$1,000 property tax deduction to a couple in the 15 percent tax bracket is only equal to a \$150 savings.

§ STA.03 Changes to Exclusion of Gain on Sale of Principal Residence

Under current law, homeowners may exclude gain on the sale of their principal residence, provided certain conditions are met.²¹ These rules allow the exclusion of \$250,000 of gain on the sale of a principal residence (\$500,000 for joint returns), provided the taxpayer both owned and used the residence as his or her principal residence for two out of the five years preceding the sale. Although vacation or rental properties do not qualify for the gain exclusion because they are not the "principal residence" of the taxpayer, taxpayers could move into a second residence and convert it to their principal residence for two years, and thus qualify for the gain exclusion. Prior to the *Housing Assistance Tax Act*, all appreciation in such a property was eligible for gain exclusion, provided the dwelling had been used as a principal residence for at least two years.

The new provision enacted by the *Housing Assistance Tax Act* provides that gain allocated to periods of nonqualified use are not eligible for the I.R.C. Section 121 exclusion.²² The "nonqualified use" is the period that the dwelling was not used by the taxpayer or the taxpayer's spouse as a principal residence. Thus, the new requirement requires the recognition of gain from sale in an amount equal to the portion of time the house was not used as a principal residence compared to the total period the taxpayer owned the property. The balance of the gain on sale remains eligible for the \$250,000/\$500,000 exclusion.

This new provision applies only to sales or exchanges after 2008.²³ In addition, periods before 2009 are not considered "nonqualified use," regardless of their actual use.²⁴ Thus, this tax planning opportunity has not been shut down retroactively.

¹⁹ I.R.C. § 63(c)(7). For taxpayers itemizing their deduction, the full amount of property taxes will still be deductible as an itemized deduction. I.R.C. § 164(a)(1).

²⁰ I.R.C. § 63(c)(1)(C).

²¹ I.R.C. § 121.

²² I.R.C. § 121(b)(4), enacted by H.R. 3221 Sec. 3092.

²³ H.R. 3221 Sec. 3092(b).

²⁴ I.R.C. § 121(b)(4)(C)(i).

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For example, assume a taxpayer buys a property on January 1, 2009, for \$400,000, and uses it as a rental property for two years, claiming depreciation deductions of \$20,000. On January 1, 2011, the taxpayer converts the property to his principal residence. On January 1, 2013, the taxpayer moves out, and on January 1, 2014, the taxpayer sells the property for \$700,000. \$20,000 of the gain, attributable to prior depreciation deductions, is not eligible for the exclusion under I.R.C. § 121 (both prior to and after the *Housing Assistance Tax Act* changes).²⁵ Of the remaining \$300,000 of gain, 40% of the gain (2 years of rental divided by five years of ownership), or \$120,000, is allocated to nonqualified use and is not eligible for the gain exclusion under I.R.C. § 121. Since the remaining gain of \$180,000 is less than the maximum of \$250,000 that can be excluded by a single taxpayer, the \$180,000 of gain is excluded from income.²⁶

§ STA.04 Changes to REIT Rules

The *Housing Assistance Tax Act* made several changes to the technical requirements of Real Estate Investment Trusts (“REITs”). Specifically:

- Foreign currency gain recognized under I.R.C. § 987 or § 988 can be excluded solely for the computation of the REIT’s 75% and 95% income tests.²⁷ The excluded amounts are excluded from both the numerator and the denominator in the income test calculations.²⁸
- The percentage of the value of REIT assets that can be held in securities of a taxable REIT subsidiary is increased from 20% to 25%.²⁹
- The prohibited transaction safe harbor for dealer sales is changed by reducing the holding period from four years to two years.³⁰ In addition, the sales test of the prohibited transaction safe harbor rules is changed from 10% of the aggregate bases of the REIT assets to either 10% of aggregate bases or 10% of the fair market value of the assets.³¹
- The Act expands the taxable REIT subsidiary exception for hotel, motel, and other transient facilities so that it also applies to health care facilities. Thus, a taxable REIT subsidiary is permitted to rent a health care facility from its parent REIT and hire an independent contractor to operate the facility. The rents paid to the REIT parent will be qualifying rental income for purposes of the 75% and 95% income tests.³²

²⁵ I.R.C. § 121(d)(6).

²⁶ Joint Committee on Taxation, Technical Explanation of Division C of H.R. 3221, JCX 63-08.

²⁷ I.R.C. § 856(c)(2), (c)(3).

²⁸ I.R.C. § 856(n), added by H.R. 3221 Sec. 3031(a).

²⁹ I.R.C. § 856(c)(4)(B)(ii), amended by H.R. 3221 Sec. 3041.

³⁰ I.R.C. § 856(b)(6)(C) and (D), amended by H.R. 3221 Sec. 3051(a).

³¹ I.R.C. § 856(b)(6)(C)(iii), amended by H.R. 3221 Sec. 3052.

³² I.R.C. § 856(d)(8)(B); § 856(d)(9); and § 856(l)(3), amended by H.R. 3221 Sec. 3061.

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- The changes to the REIT provisions are generally effective for tax years beginning after the date of enactment. However, the rules treating certain foreign currency gain as excluded income for purposes of the income test apply to income recognized after the date of enactment, and the provisions relating to the prohibited transactions tax safe harbor apply to sales made after the date of enactment.³³

§ STA.05 Low Income Housing Tax Credit Changes

The *Housing Assistance Tax Act* also liberalized certain aspects of the low-income housing tax credit.

- The low-income housing credit provided in I.R.C. § 42 may be claimed over a ten-year period by owners of certain residential rental properties that are occupied by tenants having incomes under specified levels. However, the low-income housing credit is allowable only if the owner of the qualified building receives a housing credit allocation from the State or local housing credit agency. The aggregate credit authority provided annually to each state for 2008 is \$2.00 per resident, with a minimum amount allowed for small population states. The *Housing Assistance Tax Act* increases from \$2.00 per resident to \$2.20 per resident the allocation authority provided annually to each state for calendar years 2008 and 2009, and increases the minimum cap for small population states by 10% for those years.³⁴
- The calculation of the annual low-income housing credit amount is designed to produce a credit equal to 70% of the building's qualified basis over the 10-year period of the credit (for non-Federally subsidized construction). The credit percentage for each year is adjusted monthly by the I.R.S. based on the Applicable Federal Rate. Because interest rates have been so low, the actual percentage for this credit had been about 7.8 percent annually. The *Housing Assistance Tax Act* provides a temporary applicable percentage of nine percent for newly-constructed non-Federally subsidized buildings placed in service after the date of enactment and before December 31, 2013.³⁵
- If a portion of the eligible basis of a low-income building is Federally-subsidized, the building is ineligible for the 70% credit and instead may be eligible for the 30% credit. The *Housing Assistance Tax Act* changes the definition of Federal subsidy for these purposes to include only obligations the interest on which is exempt from tax under I.R.C. § 103. The definition of Federal subsidy used to include Federal loans if the interest rate was less than the Applicable Federal Rate. Thus, effective for buildings placed in service after the date of enactment, additional buildings may become eligible for the

³³ H.R. 3221, Sec. 3071.

³⁴ I.R.C. § 42(h)(3)(I), as amended by H.R. 3221 Sec. 3001.

³⁵ I.R.C. § 42(b)(2), as amended by H.R. 3221 Sec. 3002(a).

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70% credit.³⁶

- A higher credit amount (91% instead of the 70% credit, and 39% instead of the 30% credit) is currently allowed for buildings located in certain high-cost areas. The *Housing Assistance Tax Act* adds an additional type of building eligible for the higher credit amount: any building designated by the state housing credit agency as requiring the enhanced credit in order for such building to be financially feasible.³⁷

In addition, certain other technical changes were made to the low-income housing credit, such as:

- Increasing the amount that must be spent on rehabilitation expenditures in order to qualify those amounts for a low-income housing credit;³⁸
- Increasing the amount of the building that may be used for community service facilities;³⁹
- Modifying the basis reduction rule for federal grants that are received during the compliance period;⁴⁰
- Modifying the definition of “related party” for purposes of the prohibition on purchasing a qualifying building from a related party;⁴¹
- Modifying the exceptions to the rule requiring a period of at least ten years between the date of an eligible building’s acquisition and the date it was placed in service;⁴²
- Eliminating the present-law prohibition against providing the low-income housing credit to buildings receiving moderate rehabilitation assistance under section 8(e)(2) of the United States Housing Act of 1937;⁴³
- Modifying the carryover allocation rule, which allows an allocation of the low-income housing credit after the close of the calendar year in which the building is placed in service;⁴⁴
- Eliminating the bond-posting requirement upon a change in ownership of the building, to avoid recapture of the credit, and replacing it with an extended statute of limitations;⁴⁵

³⁶ I.R.C. § 42(i)(2)(A), as amended by H.R. 3221 Sec. 3002(b).

³⁷ I.R.C. § 42(d)(5)(B)(v), as amended by H.R. 3221 Sec. 3003(a).

³⁸ I.R.C. § 42(e)(3)(A)(ii), as amended by H.R. 3221 Sec. 3003(b).

³⁹ I.R.C. § 42(d)(4)(C)(ii), as amended by H.R. 3221 Sec. 3003(c).

⁴⁰ I.R.C. § 42(d)(5)(A), as amended by H.R. 3221 Sec. 3003(d).

⁴¹ I.R.C. § 42(d)(2)(D)(ii), as amended by H.R. 3221 Sec. 3003(e).

⁴² I.R.C. § 42(d)(6), as amended by H.R. 3221 Sec. 3003(f).

⁴³ I.R.C. § 42(c)(2), as amended by H.R. 3221 Sec. 3004(a).

⁴⁴ I.R.C. § 42(h)(1)(E)(ii), as amended by H.R. 3221 Sec. 3004(b).

⁴⁵ I.R.C. § 42(j)(6), as amended by H.R. 3221 Sec. 3004(c).

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- Adding two additional criteria that a State must use in its allocation of credits among potential low-income housing projects: (1) the energy efficiency of the project, and (2) the historic nature of the project;⁴⁶
- Adding an additional exception to the general rule that student housing is not eligible for the low-income housing credit in the case of a student who was previously under the care and placement responsibility of a foster care program;⁴⁷
- Modifying the measurement of an area’s median gross income, for qualification for low-income housing, for projects in certain rules areas;⁴⁸
- Clarifying the rule that units in a qualified low-income housing project must be available for use by the general public;⁴⁹
- Excluding, in certain circumstances, military basic housing allowances in determining a tenant’s low-income eligibility;⁵⁰ and
- Excluding, in certain circumstances, military basic housing allowances in determining a tenant’s low-income eligibility; and
- Conforming the tax-exempt bond rules to the low-income housing credit rules in several respects (the “next available unit rule,” the rules applicable to full-time students, and the rules concerning single room occupancy units).⁵¹

§ STA.06 Changes Related to Tax-Exempt Housing Bonds

The *Housing Assistance Tax Act* has made several changes to temporarily liberalize the rules regarding tax-exempt housing bonds. The Act authorizes an additional \$11 billion of volume cap for 2008 for the purpose of issuing qualified mortgage bonds or private activity bonds for qualified residential rental projects.⁵² The mortgage bonds issued under the new volume cap may be used to finance either new mortgages or qualified subprime loans. The *Housing Assistance Tax Act* also creates an exception to the “new” mortgage requirement for qualified mortgage bonds by authorizing the use of such bonds to refinance a qualified subprime loan.⁵³ Furthermore, bonds guaranteed by Federal Home Loan Banks are now eligible for treatment as tax-exempt bonds.⁵⁴ Also, the first-time home buyer requirement for qualified tax-exempt mortgage bonds

⁴⁶ I.R.C. § 42(m)(1)(c), as amended by H.R. 3221 Sec. 3004(d).

⁴⁷ I.R.C. § 42(i)(3)(D)(i), as amended by H.R. 3221 Sec. 3004(e).

⁴⁸ I.R.C. § 42(i)(8), as amended by H.R. 3221 Sec. 3004(f).

⁴⁹ I.R.C. § 42(g)(9), as amended by H.R. 3221 Sec. 3004(g).

⁵⁰ I.R.C. § 142(d)(2)(B)(ii), as amended by H.R. 3221 Sec. 3005.

⁵¹ I.R.C. § 142(d)(3)(C), as amended by H.R. 3221 Sec. 3008(a); I.R.C. § 142(d)(2)(C), as amended by H.R. 3221 Sec. 3008(b); I.R.C. § 142(d)(2)(D), as amended by H.R. 3221 Sec. 3008(c).

⁵² I.R.C. § 146(d)(5), as amended by H.R. 3221 Sec. 3021(a).

⁵³ I.R.C. § 143(k)(12), as amended by H.R. 3221 Sec. 3021(b).

⁵⁴ I.R.C. § 149(b)(3)(A)(iv), as amended by H.R. 3221 Sec. 3023.

is waived for residences located in Presidentially declared disaster areas.⁵⁵

§ STA.07 Repeal of AMT Limitations on Tax-Exempt Housing Bonds, Low Income Housing Credit, and Rehabilitation Credit

In determining alternative minimum tax (“AMT”), a taxpayer’s taxable income is modified to take into account certain preference items.⁵⁶ The *Housing Assistance Tax Act* modifies these preference items by providing that tax-exempt interest on (i) certain exempt facility bonds used to provide qualified residential rental projects, (ii) qualified mortgage bonds, and (iii) qualified veterans’ mortgage bonds, is not an item of tax preference.⁵⁷ In addition, the Act allows the low-income housing tax credit and the rehabilitation credit to offset AMT liability.⁵⁸

§ STA.08 Modifications to Gulf Opportunity Zone Incentives

Under current law, a taxpayer who suffers a casualty loss can deduct that loss, subject to certain limitations, in the year in which the loss occurred, or, if a disaster loss was in a Presidentially-declared disaster area, the deduction can be taken in the year prior to the disaster.⁵⁹ Any subsequent reimbursements of those losses are generally taken into income when received. The *Housing Assistance Tax Act* contains a provision allowing taxpayers who claimed a casualty loss to a principal residence resulting from Hurricanes Katrina, Rita, or Wilma, and who receive a grant as reimbursement in a subsequent year, to elect to file an amended return for the taxable year in which the deduction was taken, rather than taking the reimbursement amount into income in the taxable year received. The time for filing the amended return is three years after the original due date for filing the tax return or one year after the date of enactment of the *Housing Assistance Tax Act*. Any underpayment of tax resulting from the reduction or elimination of the casualty loss deduction is not subject to any interest or penalty if the tax is paid not later than one year after the filing of the amended return.⁶⁰

In addition, the *Housing Assistance Tax Act* removes the deadline of January 1, 2008, for the commencement of construction for self-constructed Gulf Opportunity Zone extension property which qualifies for additional first-year depreciation. However, the placed-in-service date of December 31, 2010, and the progress expenditure date of January 1, 2010 are not modified.⁶¹

§ STA.09 Miscellaneous Items

- The *Housing Assistance Tax Act* increases from 35% to 50% the percentage of the property that may be leased to a tax-exempt entity in a disqualified lease

⁵⁵ I.R.C. §143(k)(11), as amended by H.R. 3221 Sec. 3026.

⁵⁶ See I.R.C. § 55(b)(2)(B) and § 57.

⁵⁷ I.R.C. §57(a)(5)(C)(iii), as amended by H.R. 3221 Sec. 3022(a).

⁵⁸ I.R.C. §38(c)(4)(B), as amended by H.R. 3221 Sec. 3022(b).

⁵⁹ I.R.C. § 165(i)(1).

⁶⁰ H.R. 3221 Sec. 3082(a).

⁶¹ I.R.C. §1400N(d)(3)(B), as amended by H.R. 3221 Sec. 3082(b).

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without requiring allocation of rehabilitation expenditures under the rehabilitation credit.⁶²

- In order to avoid withholding on the disposition of a U.S. real property interest by a foreign person, a transferor can issue an affidavit to the transferee of the property, indicating that the transferor is not a foreign person.⁶³ The *Housing Assistance Tax Act* provides an alternate procedure: in lieu of furnishing a non-foreign affidavit to the transferee, a transferor may furnish such affidavit to a qualified substitute.⁶⁴
- Corporations otherwise eligible for bonus depreciation under I.R.C. § 168(k) may elect to claim additional research or minimum tax credits in lieu of claiming depreciation under I.R.C. § 168(k) for eligible qualified property placed in service after March 31, 2008.⁶⁵

§ STA.10 Revenue Offsets

The nearly \$15 billion cost of the *Housing Assistance Tax Act* is offset by the following provisions:

- **Modification of Principal Residence Gain Exclusion.** As discussed above, I.R.C. § 121, excluding gain from the sale of a principal residence, is modified to eliminate gain exclusion due to periods of nonqualified use.⁶⁶
- **Increased Information Reporting.** The *Housing Assistance Tax Act*⁶⁷ adds I.R.C. § 6050W, effective for returns for calendar years beginning December 31, 2010, which requires an information return for reporting payments made in settlement of payment card and third-party payment transactions. Thus, under this provision, a bank that enrolls a business to accept credit cards and contracts with the business to make payment on credit card transactions is required to report to the I.R.S. the business’s gross credit card transactions for each calendar year. The bank is also required to provide a copy of the information report to the business.
- **Delay in Application of Worldwide Allocation of Interest.** In order to determine its taxable income from foreign sources, a taxpayer must allocate and apportion deductions between items of U.S.-source and foreign-source gross income. The American Jobs Creation Act of 2004 modified the rules for allocating interest expense, effective for taxable years beginning after December 31, 2008. The *Housing Assistance Tax Act* delays the effective date of the worldwide interest allocation rules for two years, until taxable years beginning

⁶² I.R.C. §47(c)(2)(B)(v)(I), as amended by H.R. 3221 Sec. 3025.

⁶³ I.R.C. § 1445(a).

⁶⁴ I.R.C. §1445(b)(9), as amended by H.R. 3221 Sec. 3024.

⁶⁵ I.R.C. §168(k)(4), as amended by H.R. 3221 Sec. 3081.

⁶⁶ I.R.C. §121(b)(4), as amended by H.R. 3221 Sec. 3092.

⁶⁷ Sec. 3091(a).

after December 31, 2010.⁶⁸

- **Timing of Corporate Estimated Taxes.** The *Housing Assistance Tax Act* makes two changes to the corporate estimated tax payment rules. First, for corporations with assets of at least \$1 billion, the payments due in July, August, and September, 2013, are increased by 16.75 percentage points of the payment otherwise due, and the next required payment is reduced accordingly. However, the similar provision in the Tax Increase Prevention and Reconciliation Act of 2005, scheduled for the July, August, and September 2012 payments, is repealed and the general rule applies (such corporations are required to make quarterly estimated tax payments based on their income tax liability).⁶⁹

⁶⁸ I.R.C. §864(f)(5)(D) & (6), as amended by H.R. 3221 Sec. 3093.

⁶⁹ H.R. 3221 Sec. 3094, modifying Sec. 401(1) of the Tax Increase Prevention and Reconciliation Act of 2005.