The Income Tax Effects of the Housing and Economic Recovery Act of 2008 on Real Estate Transactions

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INTRODUCTION

If real estate investors are to maximize after-tax profits and maintain appropriate levels of capital investment, they must have a working knowledge of the latest legislative changes enacted by the United States Congress that pertain to real estate. On July 30, 2008, President George W. Bush signed into law the Housing and Economic Recovery Act of 2008 (hereinafter Act). This sweeping piece of legislation contains, among other things, numerous amendments to the Internal Revenue Code. Several of the provisions of the Act have implications for real estate investors and/or real estate transactions.

The purpose of this article is to summarize the provisions of several of the important changes to the Internal Revenue Code that are now the law or that will soon become the law and that pertain to real estate transactions. Investors in real estate are urged to look closely at this tax legislation to seek ways in which they can significantly diminish their future income taxes. The following discussions focus on the major provisions of the new bill which, directly or indirectly, affect real estate transactions. Some suggestions for tax planning are also included in the discussions. To determine the particular effect, if any, each of these provisions will have on a particular investment, each investor should consult with his/her CPA, tax attorney or other tax professional.

LOW-INCOME HOUSING TAX CREDIT

The Act states that the low-income housing tax credit for new buildings placed in service after the date of enactment of this change (July 30, 2008) and before Dec. 31, 2013, shall be subject to a tax credit rate of not less than nine percent. The nine percent rate applies only to new construction and substantial rehabilitation projects that are not subsidized by the federal government. The applicable rate for new buildings that are federally subsidized or are existing buildings is four percent. The appropriate credit may be taken for 10 consecutive years on the low-income housing project. A loan including federal funds is not considered to be subsidized if the loan bears an interest rate that is at or above the prevailing Treasury interest rate.

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The basis that is available for the credit is determined in three basic steps and one additional step. In step one, the eligible basis is determined. Eligible basis includes all depreciable construction costs and all depreciable "soft" costs such as architectural fees and engineering costs. Non-depreciable costs such as the cost of the land are excluded from the eligible basis. In step two, the fraction of qualified low-income housing units is determined. The applicable fraction is the lower of the percentage of low-income units to total units or the square footage occupied by low-income units out of the total square footage for the project. In step three, the basis amount that qualifies for the low-income housing credit is determined. In the additional step, the credit may be increased up to an additional 30 percent. This extra credit is only available for areas that are designated as Qualified Census Tracts (QCTs) or Difficult Development Areas (DDAs) by the U.S. Department of Housing and Urban Development (HUD).[1]

SAMPLE COMPUTATION:

A local real estate developer is proposing to build 100 rental units in Boomtown, U.S.A. The developer will not use any additional federal funds. The development will not be located in a DDA or a QCT. Forty-five percent of the units and forty percent of the square footage will be set aside for low-income households. The total development costs for the project are estimated as follows:

Land Acquisition	**$2,000,000**
Dwelling Construction	**7,170,000**
Site Improvements	**700,000**
Architectural/Engineering	**80,000**
Other Eligible Soft Costs	**50,000**
Total Development Costs	**$10,000,000**

Generally, the value of the tax credit is calculated as follows:

- **Eligible Basis = $8,000,000 (Total Development Costs – Land Cost)**
- **Qualified Basis = $3,200,000 (Eligible Basis x Applicable Fraction: $8,000,000 x 40%)**
- **Annual Credit = $288,000 ($3,200,000 x 9% Credit Rate)**
- **Total Amount of Housing Tax Credits = $2,880,000 ($288,000 x 10 years)**

Tax Planning Tips: Since the above change is temporary and expires on Dec. 31, 2013, developers who wish to qualify for the low-income housing credit should make sure that construction projects are completed and the housing is placed in service prior to Jan. 1, 2014. Developers also should consider avoiding federally subsidized loans so that the projects qualify for the nine percent credit rather than the four percent credit.

FIRST-TIME HOMEBUYER CREDIT

The Housing and Economic Recovery Act of 2008 offers a first-time homebuyer credit. This credit is available to a first-time homebuyer of a principal residence in the United States during a taxable year. The credit is refundable in a manner similar to the earned income credit. In other words, the taxpayer will receive the credit in the form of a refund even if the tax liability for the year is zero. The credit is an amount equal to 10 percent of the purchase price of the principal residence, up to a maximum of $7,500. This credit is equivalent to an interest-free loan because taxpayers receiving the credit must repay any amount received under this provision back to the federal government over 15 years in equal installments. The provision applies to homes purchased on or after April 9, 2008, and before July 1, 2009. This credit begins to phase out for taxpayers with an adjusted gross income in excess of $75,000 ($150,000 in the case of a joint return).

The repayment provision of the Act calls for repayment to begin in the second taxable year after the taxable year during which the home is purchased. For example, if the taxpayer purchases a home in 2008, the credit is allowed on the 2008 tax return, and repayment begins with the 2010 tax return. If the taxpayer sells the home prior to complete repayment of the credit, any remaining credit repayment amount is due on the tax return for the year during which the home is sold (or ceases to be used as the principal residence). No amount is recaptured after the death of a taxpayer. In the case of an involuntary conversion of the home, recapture is not accelerated if a new principal residence is acquired within a two-year period. In the case of a transfer of the residence to a spouse or to a former spouse because of divorce, the transferee spouse (and not the transferor spouse) will be responsible for any future recapture.[2]

Tax Planning Tips: An individual or married couple who has had no ownership interest in a principal residence during the three-year period ending on the date of the

purchase of a principal residence will qualify as a first-time homebuyer. Also, a residence that is constructed by a taxpayer is treated as purchased by the taxpayer on the date the taxpayer first occupies the residence.

ALTERNATIVE MINIMUM TAX CHANGES

The alternative minimum tax (AMT) can increase the cost of implementing housing programs. Under current tax law, the interest on tax-exempt housing bonds is subject to the AMT. The potential taxability of this interest under the AMT limits the marketability and the incentive effect of these bonds. In addition, under current tax law, both the low-income housing tax credit and the rehabilitation tax credit (the rehabilitation credit applies to costs incurred for rehabilitation and reconstruction of historic structures and buildings built before 1936) cannot be taken as offsets against the AMT. Thus the incentive effects of these credits are limited.

The Housing and Economic Recovery Act of 2008 eliminates these impediments imposed by the AMT on housing programs. The bill would allow the low-income housing tax credit and the rehabilitation tax credit to be used to offset the AMT and would ensure that interest on tax-exempt housing bonds is not subject to the AMT. This portion of the Act applies to interest on tax-exempt housing bonds issued after the enactment date of the Act (July 30, 2008). The low-income housing credit amendment is effective for buildings placed in service after Dec. 31, 2007. The rehabilitation credit amendment is effective for qualified rehabilitation expenditures properly taken into account for periods after Dec. 31, 2007.[3]

Tax Planning Tip: Many parts of the Act are temporary and designed to help stimulate the real estate market in the short term. These AMT changes are an actual permanent repeal of the applicable provisions.

REAL ESTATE INVESTMENT TRUST REFORMS

The Housing and Economic Recovery Act of 2008 contains a number of provisions to liberalize the rules regulating real estate investment trusts (REITS). REITs are subject to several complex rules that can limit the ability of these businesses to adjust to changing market conditions and to properly manage risk. The Act relaxes these rules in several ways.[4] First, the Act shortens the prohibited transactions (i.e., a sale of property held primarily for sale to customers in the ordinary course of business, or "dealer property") safe harbor holding period from four years to two. A REIT is potentially subject to a tax equal to 100 percent of the net income derived from a prohibited transaction. Under prior law, the safe harbor rules applied to a sale of real property if, among other requirements, the REIT held the property for at least four years for the production of rental income, and the aggregate expenditures made by the REIT during the four-year period preceding the date of sale that were capital expenditures did not exceed 30 percent of the net selling price of the property. The Act shortens the minimum holding period under the safe harbor and the period during which the limit on capital expenditures applies from four years to two years. This gives REITs more flexibility to dispose of properties without risk of the 100 percent tax being imposed, provided the other requirements of the safe harbor are met.[5]

The Act also eases the rules concerning a REIT's foreign currency income associated with real estate activities. Under prior law, the definition of a REIT included the following provisions: 1) at least 95 percent of its gross income is derived from dividends, interest, rents from real property, gain from the sale or other disposition of stock, securities, real property, and several other items; 2) at least 75 percent of a REIT's gross income is derived from rents from real property, interest on obligations secured by mortgages on real property or on interests in real property; gain, from sale or disposition of real property, etc.[6] The prior 95 percent and 75 percent test included foreign currency gains as gross income in applying both tests. Foreign currency gains arise due to fluctuations in foreign currency between the time a REIT accrues rent or interest income, until the time it collects the income. Under the Housing and Economic Recovery Act of 2008, certain foreign currency gains are excluded from gross income in applying the 95 percent and 75 percent tests.

Tax Planning Tips: With the above changes in the rules for REITs, taxpayers may find that it is easier to qualify real estate investments as a REIT when engaging in foreign currency transactions. In addition, the new two-year safe harbor rule may allow real estate investors to sell their REIT investments sooner and realize the lower capital gains tax rates that are currently in effect.

MODIFICATION OF EXCLUSION OF GAIN ON SALE OF PRINCIPLE RESIDENCE

Generally, a gain on sale of most property is taxable. However, Internal Revenue Code Section 121 provides an exception to this general rule. Under Section 121, a homeowner selling a personal residence is permitted to

exclude up to $250,000 ($500,000 if married filing jointly) of realized gain. To qualify for this favorable tax treatment, the residence must have been occupied for at least two years during the five-year period ending on the date of the sale. This five-year window allows a taxpayer to qualify for the Section 121 exclusion even though the property was not the taxpayer's principal residence at the date of the sale. Astute real estate investors have been taking advantage of this tax loophole for years. For example, an investor could purchase a home and use it as the principal residence for two years and then use it as rental property for the next couple of years. Or, alternatively, an investor could convert a rental house to a primary residence, live in it for two years, then sell it and qualify for the exclusion. In other words, in both of the above cases the investor could sell the house and take advantage of Section 121 and exclude up to $250,000 ($500,000 for joint filers) of his/her capital gain.

The Housing and Economic Recovery Act of 2008 amends Section 121 of the Internal Revenue Code so that if there were any non-qualified use of the real property prior to the property being used as the primary residence, the total tax-free exclusion is no longer available. Non-qualified use is defined as any use of the property other than as a primary residence. This includes use as a second home, a vacation property, a rental property or an investment property. It also includes use of the home in a trade or business.

The distinction between qualified and non-qualified use is important, and the timing of the qualified and non-qualified use is important. Homeowners/investors can no longer take the full tax-free exclusion under Section 121 when the property was held and used for non-qualified use prior to being held and used as a primary residence. When non-qualified use occurs prior to qualified use, the capital gain resulting from the sale of the property will be allocated between qualified and non-qualified use periods based upon the amount of time the property was held and used for qualified versus non-qualified use. The capital gain allocated to the non-qualified use period will no longer be excluded from the homeowner/investor's taxable income. The capital gain allocated to the qualified use period (personal primary residence) will still qualify for the Section 121 exclusion and will be excluded from the taxpayer's taxable income.

Homeowners will not have to determine when the property actually appreciated in value. Appraisals are not needed or required. The change or fluctuation in the fair market value of the property each year during the time the home is owned doesn't matter. The total capital gain recognized upon the actual sale of the property is all that matters. The capital gain recognized upon actual sale will be allocated between non-qualified and qualified use periods in order to determine the amount of gain to be excluded from taxable income under Section 121 due to qualified use, and the corresponding amount of capital gain that will be included in taxable income under Section 121 due to non-qualified use. The allocation of the gain between qualified and non-qualified use periods is very simple. Gain is allocated using a fraction based on the number of years the property was held for qualified use over the number of years of total use.

EXAMPLE:

A homeowner owned real property for eight years. The property was held as rental property for the first six years and then the property was converted to use as a primary residence. The use as a primary residence lasted for two years. The qualified use period is two years and the non-qualified use period is six years. Therefore, two-eighths, or one-fourth of the total actual capital gain is excluded from taxable income while six-eighths, or three-fourths of the capital gain is included in the taxpayer's taxable income. Remember that depreciation recapture cannot be excluded from taxable income under Section 121, and would be recognized and included as income in the year the property is actually sold.[7]

Tax Planning Tip: Property that is held as a primary residence first and then converted to investment or business property use will still qualify for the full Section 121 exclusion. The proration of the gain discussed above only occurs when investment property is converted to use as a primary residence. Therefore, real estate investors who know they will be converting property between investment and personal use should use the property as a primary residence first (for at least two years) and then convert it to investment use. This change in the Internal Revenue Code is expected to generate more than one billion dollars in new tax revenue for the federal government over the next ten years. The above changes are effective for sales or exchanges that occur after Dec. 31, 2008.

TAX-EXEMPT BONDS

Under current law, municipal bonds that are guaranteed by Federal Home Loan Banks do not qualify as tax-exempt unless the bonds are used to finance housing

programs. The Act helps municipalities by temporarily allowing these bonds to be tax-exempt even when they are not used to finance housing programs. This temporary change will make it easier for local and state governments to obtain financing to build roads, repair bridges, build schools, etc. This change expires at the end of 2010.[8]

Tax Planning Tip: Investors looking for tax-exempt income should take advantage of the ability to purchase these newly exempted bonds between now and Dec. 31, 2010.

RECENT TAX CHANGES: UPDATE

In October 2008, Congress passed the Emergency Economic Stabilization of 2008. Some relevant provisions follow. Depreciation at a 50 percent rate is allowed in the year that reuse and recycling property is placed into service. Reuse and recycling property includes machinery and equipment that is used to collect, distribute or recycle materials such as plastic, glass, rubber, metal, etc. One provision allows the deduction of energy credits for solar, fuel cell and microturbine technology against the alternative minimum tax. Another provision allows a tax credit for residential energy-efficient property such as wind, solar or geothermal. Still another provision raised the alternative minimum tax exemption amount to $69,950 for married filing jointly ($46,200 for single) for 2008.[9]

On Dec. 29, 2008, the Internal Revenue Service issued Revenue Procedure (Rev. Proc.) 2008-68 to provide temporary relief to REITs. This relief will allow REITs to preserve cash by allowing the issuance of stock dividends. Under this new Rev. Proc., REITs are allowed to cap the cash portion of a dividend at 10 percent (the remaining 90 percent can be a stock dividend). This Rev. Proc. applies only to REITs that are publicly traded on an established securities market in the United States. The effective date of this Rev. Proc. is Jan. 1, 2008. Dividends declared with respect to a taxable year ending on or before Dec. 31, 2009 are covered by this Rev. Proc.[10]

On Feb. 17, 2009, the American Recovery and Reinvestment Tax Act of 2009 became law. This Act further increases the alternative tax exemption amount to $70,950 for married filing jointly ($46,700 for single) for tax years beginning after Dec. 31, 2008 (i.e., beginning in 2009). The 2009 Act extends from two to five years the carryback period for net operating losses incurred in 2008. This five-year carryback is for small businesses with $15 million or less in gross receipts. The bill also extends the 50 percent write-off of capital expenditures incurred to purchase depreciable property (e.g., equipment, tractors, wind turbines, solar panels and computers) acquired in 2009 for use in the United States.[11]

CONCLUSION

This article has attempted to summarize some of the tax changes in the Housing and Economic Recovery Act of 2008 (and some recent legislation). The focus has been on the changes that would directly or indirectly affect real estate investors and/or real estate transactions. The author sees no movement toward tax simplification by the U.S. Congress and the president, but the Housing and Economic Recovery Act of 2008, one hopes, will meet the objectives of improving the economy and providing some relief to taxpayers. Real estate investors have many opportunities created by the new tax rules to reduce their tax burdens. However, a law as complicated as this Act commands a great deal of study by investors who desire to maximize returns and minimize the tax burden. Real estate investors should consult with appropriate tax professionals to assure proper application and maximum benefit from this new tax Act. ■

ENDNOTES

1. *http://www.tnmha.net/untitled/Publication3.pdf.*
2. H.R. 3221.
3. *http://www.hud.gov/offices/cpd/about/conplan/foreclosure/senatefinancesummary.pdf.*
4. *http://www.hud.gov/offices/cpd/about/conplan/foreclosure/senatefinancesummary.pdf.*
5. *http://www.mondaq.com/article.asp?articleid=64256.*
6. Internal Revenue Code, Section 856.
7. *http://www.exeterco.com/article_changes_to_section_121.aspx.*
8. *http://www.icba.org/files/ICBASites/PDFs/hr3221summary.pdf.*
9. *http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_bills&docid=f:h1424enr.txt.pdf.*
10. *http://www.irs.gov/irb/2008-52_IRB/ar12.html.*
11. *http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h1enr.txt.pdf.*