

**AIMS Tax Update
NAA/NMHC Joint Legislative Program**

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HOUSING STIMULUS LEGISLATION

The housing stimulus bill (H.R. 3221) signed into law this week has been one of NAA/NMHC's top priorities this year, and as a result of our efforts it includes several important victories for the apartment industry. In addition to provisions in the bill to create a new regulatory regime and federal backstop for Fannie Mae and Freddie Mac and provide \$300 billion in refinancing assistance for homeowners facing foreclosure, the measure also includes a \$15.1 billion package of tax incentives. Of interest to apartment firms are provisions to expand and improve the Low-Income Housing Tax Credit (LIHTC) program and new tax provisions related to homeownership. (For an overview of the non-tax provisions of the bill, please see this week's *AIMS Washington Update*.)

Low-Income Housing Tax Credit

The final housing package increases the annual per capita cap for the Low-Income Housing Tax Credit from \$2.00 to \$2.20 in 2008 and 2009 and helps to restore liquidity to the LIHTC program by allowing the credits to offset Alternative Minimum Tax (AMT) liabilities for buildings placed in service after December 31, 2007. The measures will also make several NAA/NMHC-supported technical corrections to the program to simplify it.

Importantly, the measure also includes an NAA/NMHC-sought provision allowing the Basic Allowance for Housing (BAH) provided to military servicemembers to be excluded from calculations of income for purposes of determining the servicemember's eligibility for the LIHTC. To qualify, servicemembers must live in a property located close to a large military base (over 1,000 servicemembers) that has seen troop level increases of 20 percent or more in recent years. The provision is through 2011. The measure also:

- Modifies the 70-percent credit to limit uncertainty by creating a flat 9-percent credit for non-federally subsidized buildings placed in service after enactment of the bill through the end of 2013.
- Extends the 70-percent credit to non-federally subsidized existing housing that is substantially rehabilitated.
- Eliminates below-market federal loans from the definition of federally subsidized properties, allowing the 9-percent credit on all federally subsidized properties except for tax-exempt bond-financed properties.
- Allows a state housing credit agency to designate a building as eligible for 130 percent of the otherwise eligible basis, even if the building is not located in a difficult development area or qualified census tract.
- Repeals the bond posting requirements and expands the applicable statute of limitations.
- Modifies the substantial rehabilitation requirements to qualify for the 70-percent credit to require that rehabilitation expenditures must equal the greater of either 20 percent (increased from 10 percent) of the adjusted basis of the building or at least \$6,000 (increased from \$3,000) adjusted for inflation, per low-income unit in the building.
- Modifies the student rule to allow those who received foster care assistance to be eligible for LIHTC apartments.
- Expands the allowable basis for community service facilities from 10 percent of the eligible basis to 15 percent up to \$5 million, and 10 percent over that amount.
- Clarifies that the eligible basis of a building shall not include any construction or rehab costs financed with the proceeds of a federally funded grant.

- Relaxes the definition of “related parties” in rules restricting investment in LIHTC properties owned by related parties by expanding allowable related party interest from 10 percent to 50 percent.
- Extends the time developers have to meet the 10-percent carryover allocation test from six months to one year.
- Clarifies that the energy efficiency and historic nature of a project are additional criteria that a state must include in its allocation criteria.
- Allows properties in certain rural areas to use the greater of the area median income or the national nonmetropolitan median gross income to determine area median gross income.
- Modifies HUD’s income limit methodology as of January 1, 2009 to require HUD to increase applicable area median incomes by the amount that area median incomes rise, even if the HUD-determined area median incomes would be frozen under HUD’s 2007 and 2008 income limit methodology.
- Waives the annual recertification requirements for 100 percent tax credit properties.
- Clarifies the next available unit rule.
- Allows the tax credits to be used on properties financed with HUD’s Section 8 Moderate Rehab program.
- Repeals the 10-year non-acquisition rule for acquisition of LIHTC properties currently subsidized by certain HUD, USDA or similar state assistance programs, including: HUD Section 8, Section 221(d)(3), Section 221(d)(4), Section 236; and USDA Section 515 or other Rural Housing Service assistance programs.
- Authorizes a number of changes to streamline the use of FHA insurance with tax credits. Eliminates the need for subsidy layering reviews of FHA-financed projects that have gone through LIHTC subsidy layering reviews and allows HUD to rely on tax credit allocating agency compliance monitoring for the purpose of periodic inspections of FHA-insured multifamily properties. Requires HUD to establish a pilot program for a streamlined review of FHA multifamily mortgage insurance loan approvals, through the appointment of a chief underwriter at FHA.
- Includes provisions to make the tax credit program work more efficiently with other HUD and USDA programs, including the Section 8 project-based voucher program. Specifically, it increases the maximum Section 8 voucher contract period from 10 years to 15 years; allows project-based voucher rents in LIHTC properties to reach maximum voucher rent, even if that exceeds the LIHTC rent; eliminates HUD’s subsidy layering review for project-based vouchers if a state or locality has completed such a review for the tax credit program; and clarifies the voucher rent reasonableness for tax credit properties.

Housing Bonds

The bill provides \$11 billion in new tax-exempt multifamily and mortgage revenue bonds in 2008. The additional volume cap must be issued by the end of 2010. In addition, the bill exempts interest earned on multifamily and mortgage revenue bonds from the AMT and allows, in certain instances, refunding of bonds used for multifamily projects. The measure also modifies the next available unit and student rules to make them consistent with the LIHTC program.

Real Estate Investment Trusts (REITs)

A number of provisions long sought by the REIT industry are also included in the package. The majority of the provisions enacted were part of the proposed REIT Investment Diversification and Empowerment Act of 2007 (S. 2002, H.R. 1147). Among other things, the bill increases the Taxable REIT Subsidiary (TRS) ownership limit from 20 percent to 25 percent, allows rents received from a TRS from the lease of certain health care facilities to constitute qualified REIT income, clarifies that certain foreign currency income earned by REITs is not included in gross income for purposes of the income tests, and modifies the REIT safe harbor for dealer sales by halving the current holding period to two years and by allowing a fair market value measurement.

Gulf Opportunity (GO) Zones

The measure allows taxpayers in affected GO Zone areas to amend prior returns to take into account receipt of hurricane-related recovery grants, waive the start-construction deadline for certain property eligible for bonus depreciation in the GO Zone and allow projects in two additional counties to qualify for tax-exempt bond financing.

Homeownership-Related Provisions

- *First-Time Homebuyers Credit.* Lawmakers originally proposed a \$15,000 tax credit for anyone who would buy a foreclosed house as their primary residence. That measure was widely criticized by academics, economists and

housing experts on both ends of the political spectrum as a policy prescription that would do more damage than good. NAA/NMHC helped persuade lawmakers that such a credit would likely increase foreclosures, accelerate house price declines and do nothing to increase housing demand.

Feeling under pressure to do something to stimulate housing demand, lawmakers instead passed a temporary tax credit for first-time homebuyers equal to 10 percent of the purchase price of a principal residence, not to exceed \$7,500. The credit is phased out for taxpayers with incomes over \$75,000 (\$150,000 for joint returns) and is only available for houses purchased between April 9, 2008 and July 1, 2009. Most importantly, taxpayers receiving the credit must repay it over 15 years in equal installments beginning two years after the credit is taken.

In effect, the credit is an interest-free loan that some observers have already said will have little impact on the market. One prominent economist estimates that the credit will save buyers at most a few hundred dollars a year—the annual value of the foregone interest—and notes that such a small incentive is not expected to influence “anxious buyers waiting on the market’s sidelines.” Another analyst notes that the “overall bill could result in more harm than good” to the single-family sector because the limited positive impact of the homebuyer credit is outweighed by the negative impact of provisions in the law that ban charitable downpayment programs, such as the ones offered by Nehemiah Corp. and AmeriDream. Some large builders report that buyers using these charitable downpayment programs account for up to one-third of their sales.

- **Standard Deduction for Nonitemizers.** The bill creates a new above-the-line deduction to allow nonitemizers to deduct up to \$500 (\$1,000 for joint filers) in state and local real property taxes for tax year 2008 only.
- **Gain on Sale of Second Houses.** To pay for the new homeownership incentives, the bill trims an existing one. Present law allows owners to exclude up to \$250,000 (\$500,000 if married) of gain if the house has been used as a primary residence for two of the five years before the sale. The housing bill amends that to require that as of January 1, 2009, any gain accrued when the home is not used as a primary residence will be taxed as capital gain (certain temporary absences due to employment or health issues are excluded).

BROWNFIELD AND ENERGY TAX INCENTIVES CAUGHT IN PARTISAN BATTLE

Efforts to extend several expired and expiring tax incentives of interest to real estate remain mired in a partisan battle over whether tax law changes should be paid for. Senate Democrats have failed four times to secure enough votes to overcome a filibuster of a House-passed bill (H.R. 6049) that would, among other things, retroactively extend the expired brownfields expensing provisions and extend for one year the temporary \$1.80 per square foot tax deduction for energy-efficient commercial buildings and the 30 percent investment tax credit for solar energy and qualified fuel cell property. The energy incentives generally expire at the end of 2008.

The most recent failures occurred this week, when twice the Senate failed to secure the 60 votes needed to allow the chamber to debate a package (S. 3335) that includes the tax extenders and a “hold harmless patch” for the AMT. Senate Republicans, and some Democrats, believe that a renewal or extension of current law should not require a “pay-for.” Many House Democrats argue that any and all tax bills should be paid for. This week’s vote was also ensnared in Republican efforts to force the Senate to complete work on an energy speculation bill (S. 3268) before moving to other business.

Similar partisan battles over paying for tax extensions prevented passage of the legislation in 2007 as well. Although the extenders enjoy strong bipartisan support, the current impasse makes the path to enactment this year unclear as Congress is set to begin its August recess today and then return for a short legislative session in September.

LOW-INCOME HOUSING TAX CREDIT (LIHTC)

- **Utility Allowances.** On July 29, the Internal Revenue Service (IRS) published long-awaited final regulations that change the way rents are adjusted on LIHTC properties when residents pay for their own utilities (73 FR 43863). The changes go into effect immediately. The new regulations, based largely on a proposal submitted to the IRS by an NAA/NMHC-led coalition, increase the sources of data that owners can use to calculate resident-paid utilities to include estimates provided by state LIHTC allocating agencies, estimates produced by a new HUD utility modeling program and certified engineering studies commissioned by property owners. The final regulations are posted at <http://edocket.access.gpo.gov/2008/pdf/E8-17268.pdf>.
- **FHA-LIHTC Streamlining.** On July 22, the U.S. Department of Housing and Urban Development (HUD) issued a memorandum making four program changes to streamline the processing of Federal Housing Administration (FHA) multifamily insurance applications with LIHTCs. The changes include allowing deferred submission of full plans and specifications, reducing the amount of tax credit equity that must be funded at the time of HUD’s initial endorsement

from 100 percent to 20 percent, relaxing the policy requiring HUD-2530 clearance to be obtained prior to FHA initial endorsement, and requiring each Multifamily Hub and Program Center to designate an LIHTC Coordinator. More information and the FHA Mortgagee Letter are available at <http://tinyurl.com/6ctpzw>.

- **Disaster Relief.** In light of recent storms, tornados, and flooding in certain Midwestern states, the IRS has waived certain LIHTC rules to allow emergency housing for displaced persons. Details of the relief may be found at Notice 2008-61 (Wisconsin), Notice 2008-56 (Indiana) and Notice 2008-58 (Iowa).

REAL ESTATE INVESTMENT TRUSTS

- In Letter Ruling 200824018 (released June 13, 2008), the IRS ruled that, for purposes of the four-year holding period requirements of the prohibited transactions tax safe harbor in section 857(b)(6)(C), the REIT's holding period of real property that was acquired as replacement property in a like-kind exchange includes the REIT's holding period of the relinquished property. Accordingly, based on certain representations, the IRS ruled that a sale of the replacement property would qualify for the prohibited transactions tax safe harbor.
- In AM 2008-003 (released February 22, 2008), the IRS has clarified that liquidating distributions of a REIT paid to a five percent or less foreign holder of its regularly traded shares are exempt from tax under section 897 (FIRPA). This guidance dispels the confusion that Notice 2007-55 created.

TAXATION OF PARTNERSHIPS

- In Revenue Ruling 2008-39 (issued July 3, 2008), the IRS discussed the deduction under sections 162 and 212 by a limited partner in an upper-tier partnership of management fees incurred at the upper-tier partnership and lower-tier partnership levels in "fund of funds" structures. The IRS held that the management fees paid by the upper-tier partnership (which acts as holding interest in the lower-tier partnerships) are section 212 expenses (i.e., generated outside of a trade or business), generally causing each individual partner's share of the management fees to be subject to the 2 percent miscellaneous itemized deduction limitations.
- On May 19, proposed regulations (REG-100798-06) were issued to modify the anti-abuse rule under section 704(c). Under the proposed regulations, the tax liabilities of both the partners in a partnership and the direct and indirect owners of such partners should be taken into account when applying the anti-abuse rule. A section 704(c) allocation method also cannot be used to obtain tax results that are inconsistent with the intent of subchapter K.
- Final regulations (T.D. 9398) were issued on May 19 that provide rules for testing the substantiality of partnership allocations under section 704(b) when the partners are look-through entities or members of a consolidated group. The regulations provide that the tax consequences resulting from the interaction of an allocation with the tax attributes of any partner and a look-through entity that is an owner of such partner must be taken into account for purpose of applying the "after-tax," "shifting," and "transitory" tests. A de minimis rule was included in the regulations.
- In T.C. Memo 2008-46, the Tax Court has held that the limited liability company (LLC) member may not treat, as an amount "at risk" under section 465, the LLC's recourse debt when the member's payment obligation is based solely on an obligation (DRO) to restore the negative amount of its capital account balance upon liquidation of the LLC.

SECTION 1031 LIKE-KIND EXCHANGES

- On July 9, the IRS published final regulations (73 FR 39614) governing the treatment of escrow accounts and other funds used in deferred 1031 like-kind exchanges. Effective for transfers occurring on or after October 8, 2008, the regulations generally continue the treatment in proposed regulations issued last February that treat exchange funds as being loaned by the taxpayer to the qualified intermediary (QI). An exception is made to this rule in situations where the QI pays all interest earned on the funds back to the taxpayer.
- In PLR 200805012, the IRS has ruled that certain development rights are considered like-kind property for purposes of a section 1031 exchange. The facts at issue involved the sale of a fee interest in a property to a third-party via a QI and a subsequent purchase from a third party of development rights allowing the taxpayer to develop a property already owned by the taxpayer with greater floor space than would otherwise be allowed. Apparently of import to the decision, local and state law clearly recognized the development rights as an "interest in real property" and of-right and not discretionary (i.e., they did not exist merely at the discretion of a government or other authority).
- The controversial farm bill became law (P.L. 110-246) on June 18 when Congress overrode President Bush's veto of the bill. In a victory for real estate interests, a provision to modify Section 1031 to disallow like-kind treatment for exchanges involving subsidized agricultural real estate (i.e., land that receives Agricultural Program Payments) and nonagricultural real estate, which had been included in an earlier version of the bill, was dropped from the final bill.

MISCELLANEA

- **Corporate AMT.** The housing bill (H.R. 3221) signed into law this week contains a provision that will allow taxpayers to elect to accelerate the recognition of up to 6 percent or \$30 million of their historic AMT credits in lieu of the bonus depreciation tax benefit that was included in the Economic Stimulus Act of 2008.
- **Capitalization of Tangible Assets.** On March 7, the IRS issued proposed regulations (73 FR 12838) to provide guidance on when expenses made with regard to tangible assets may be expensed under section 162 and when those expenses must be capitalized under section 263. Generally under the new rules, items that 1) result in a betterment of property, 2) restore the property or 3) adapt the property to a new or different use would be required to be capitalized. For purposes of applying the proposed regulations, a building and its structural components would be treated as a single unit of property. Certain de minimis rules were also included in the proposed regulations.
- **GO Zones.** In Notice 2008-25, the IRS indicates that if a taxpayer takes advantage of the additional first year depreciation available to certain GO Zone properties and that property is subsequently part of a 1031 exchange or 1033 involuntary conversion, then the replacement property must also meet the GO Zone requirements or the taxpayer must recapture the accelerated depreciation.
- **Real Estate Mortgage Investment Conduits.** In Rev. Proc. 2008-28 (issued May 16, 2008) and Rev. Proc. 2008-47 (issued July 8, 2008), the IRS has indicated that it will not challenge the tax status of certain REMICs based on modifications to certain residential mortgage loans held by the REMICs. To qualify, the modified mortgages must meet a number of criteria set forth by the IRS.

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