PRESENT LAW AND BACKGROUND RELATING TO RESIDENTIAL REAL ESTATE

Scheduled for a Public Hearing
Before the
SENATE COMMITTEE ON FINANCE
on March 7, 2023

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on March 7, 2023, entitled "Tax Policy's Role in Increasing Affordable Housing Supply for Working Families." This document,[1] prepared by the staff of the Joint Committee on Taxation ("Joint Committee staff"), provides general background on the tax provisions related to residential housing. The first part of this document describes the tax provisions related to homeownership. The second part describes the tax provisions related to rental housing. The third part provides a discussion of the economic incentives and data related to homeownership. The fourth part provides a discussion of the economic incentives and data related to rental housing. Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

[1] This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background Relating to Residential Real Estate* (JCX-4-23), March 3, 2023. This document can be found on the Joint Committee on Taxation website at www.jct.gov.

I. TAX PROVISIONS FOR HOMEOWNERSHIP

A. Home Mortgage Interest Deduction

Under an exception to the broad rule disallowing a non-corporate taxpayer a deduction for interest referred to as "personal interest," an individual taxpayer who elects to itemize deductions instead of claiming the standard deduction is allowed a deduction for qualified residence interest.[2] Qualified residence interest means interest that an individual taxpayer pays or accrues during the taxable year on acquisition indebtedness with respect to a qualified residence of the taxpayer.[3]

A qualified residence of an individual taxpayer means the taxpayer's principal residence (within the meaning of section 121) and one other residence selected by the taxpayer.[4] Under this definition a house, condominium, cooperative, mobile home, or boat may be considered a qualified residence.[5]

For a taxable year beginning before January 1, 2018 or after December 31, 2025, qualified residence interest also includes interest that an individual taxpayer pays or accrues during the year on home equity indebtedness with respect to the taxpayer's qualified residence.[6]

Acquisition indebtedness

Acquisition indebtedness is indebtedness that an individual taxpayer incurs in acquiring, constructing, or substantially improving any qualified residence of the taxpayer and that is secured by that residence.[7]

Acquisition indebtedness also generally includes indebtedness that is secured by an individual taxpayer's qualified residence and that results from the refinancing of indebtedness that was considered acquisition indebtedness either under the general definition (that is, indebtedness that was incurred to acquire, construct, or substantially improve the residence and that was secured by the residence) or under this special rule for refinancing indebtedness.[8] The amount of refinancing indebtedness that may be treated as acquisition indebtedness under this

[2] Sec. 163(a), (h)(2). "Personal interest" encompasses interest other than trade or business interest, investment interest, and certain other limited categories of interest including qualified residence interest. Sec. 163(h)(2).

[3] Sec. 163(h)(3)(A)(i).

[4] Sec. 163(h)(4)(A)(i).

[5] *Ibid.* (referencing the section 280A(d)(1) rules for a "dwelling unit").

[6] Sec. 163(h)(3)(A)(ii), (F)(i)(I).

[7] Sec. 163(h)(3)(B)(i).

[8] *Ibid.*

special rule is limited to the amount of the acquisition indebtedness that was refinanced.[9] For example, if an individual taxpayer incurs $200,000 of acquisition indebtedness to buy a principal residence, repays $50,000 of the indebtedness, and refinances the remaining $150,000 of outstanding indebtedness, the individual taxpayer's acquisition indebtedness with respect to the residence may not exceed $150,000, regardless of the amount of indebtedness that the taxpayer incurs by refinancing acquisition indebtedness.

Under Public Law 115-97, the total amount of indebtedness incurred after December 15, 2017 that may be treated as acquisition indebtedness may not exceed $750,000 (or $375,000 in the case of a married individual filing a separate return), a reduction from the prior law limitation of $1 million (or $500,000 in the case of a married individual filing a separate return).[10] The limitation on the total amount of indebtedness that may be treated as acquisition indebtedness reverts to the higher $1 million and $500,000 amounts in 2026 (regardless of when the indebtedness is incurred).[11]

Home equity indebtedness

Public Law 115-97 eliminated the deduction for interest paid on home equity indebtedness in any year from 2018 through 2025.[12]

Prepaid interest

If a taxpayer uses the cash method of accounting, prepaid interest -- that is, interest paid by the taxpayer that is properly allocable to a period with respect to which the interest represents a charge for the use or forbearance of money and that is after the close of the taxable year in which paid -- generally must be capitalized and treated as paid in the period to which it is allocable (that is, amortized over the term of the indebtedness).[13] This rule does not, however, generally apply to points paid in respect of indebtedness incurred in connection with the

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[9] *Ibid.*

[10] Sec. 163(h)(3)(F)(i)(II), (III), (h)(3)(B)(ii). The $750,000 and $375,000 limitations are reduced (but not below zero) by the amount of indebtedness that was incurred before December 15, 2017 and is subject to the $1 million or $500,000 limitation. Under a special transition rule, if an individual taxpayer entered into a written binding contract before December 15, 2017 to close on the purchase of a principal residence before January 1, 2018 and actually purchased the residence before April 1, 2018, indebtedness incurred on or before April 1, 2018 is not subject to the reduced limitation. Sec. 163(h)(3)(F)(i)(IV).

[11] Sec. 163(h)(3)(F)(ii).

[12] Sec. 163(h)(3)(F)(i)(I). For periods before and after the temporary elimination of this deduction, home equity indebtedness means indebtedness secured by the individual taxpayer's qualified residence to the extent the aggregate amount of such indebtedness does not exceed the difference between the fair market value of the residence and the total acquisition indebtedness with respect to the residence, and never in excess of $100,000 (or $50,000 for a married individual filing a separate return). Sec. 163(h)(3)(C)(i), (ii). In years not subject to the temporary elimination of the deduction for home equity indebtedness interest, this interest is deductible even if the proceeds of the indebtedness are used to pay costs, such as for vehicles, education, medical care, or vacations, unrelated to a qualified residence.

[13] Sec. 461(g)(1).

purchase or improvement of, and secured by, a taxpayer's principal residence.[14] As a consequence, if these points would be deductible as qualified residence interest if they were not prepaid, a deduction is generally allowed for the points in the year in which they are paid (but only if the points are paid in respect of indebtedness incurred for the purchase or improvement of an individual taxpayer's principal residence).

Private mortgage insurance

Under a temporary provision that expired at the end of 2021, certain premiums that an individual taxpayer paid or accrued for qualified mortgage insurance in connection with acquisition indebtedness secured by the taxpayer's qualified residence were treated as deductible qualified residence interest.[15] The amount otherwise allowable as a deduction was phased out ratably by 10 percent for each $1,000 (or $500 for a married individual filing a separate return) by which the individual taxpayer's adjusted gross income exceeded $100,000 (or $50,000 for a married individual filing a separate return).[16]

For this purpose, qualified mortgage insurance meant mortgage insurance provided by the Department of Veterans Affairs, the Federal Housing Administration, or the Rural Housing Service, and private mortgage insurance (defined in section 2 of the Homeowners Protection Act of 1998 as in effect on the date of enactment of the temporary qualified mortgage insurance provision (December 20, 2006)).[17]

Amounts paid in a taxable year for qualified mortgage insurance that were properly allocable to periods after the close of that year were treated as paid in the period to which they are allocated. No deduction was allowed for the unamortized balance if the mortgage was paid before its term (except in the case of qualified mortgage insurance provided by the Department of Veterans Affairs or Rural Housing Service).[18]

The deduction for qualified mortgage insurance premiums was not allowed with respect to any mortgage insurance contract issued before January 1, 2007 and is not allowed for any amount paid or accrued after December 31, 2021, or properly allocable to any period after that date.[19]

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[14] Sec. 461(g)(2).

[15] Sec. 163(h)(3)(E)(i).

[16] Sec. 163(h)(3)(E)(ii).

[17] Sec. 163(h)(4)(E).

[18] Sec. 163(h)(4)(F).

[19] Sec. 163(h)(3)(E)(iii), (iv).

B. Deduction for Real Property Taxes

An individual taxpayer who itemizes deductions rather than claiming the standard deduction is allowed a deduction for State, local, and foreign, real property taxes.[20] An individual taxpayer may deduct the tax if it is based on the assessed value of the real property and the taxing authority charges a uniform rate on all property in its jurisdiction. The tax must be for the welfare of the general public and not be a payment for a special privilege granted or service rendered to the individual taxpayer.[21]

Deductible real property taxes do not include itemized charges for services to specific property or people even if paid to the taxing authority. Charges for services include itemized charges such as a fixed charge per gallon of water used, a periodic charge for residential trash collection service, or a flat fee for a single service provided by the taxing jurisdiction (such as for mowing your lawn because its height exceeded that permitted by local ordinance).

Assessments for local benefits that tend to increase the value of the property are not deductible.[22] These include assessments for the construction of new streets and sidewalks, or impact fees to connect to a water or sewer system. Assessments for repair or maintenance or financing costs of existing local benefits are deductible. If only part of the assessment is for repair, maintenance, or financing costs, the taxpayer must be able to show the amount of that part to claim any deduction for that assessment.

Transfer taxes on the sale of a personal residence are not deductible real property taxes. Transfer taxes paid by the buyer are included in the cost basis of the property. Transfer taxes paid by the seller reduce the amount realized on the sale.

Assessments imposed by a homeowners' association are not deductible as real property taxes.

The deduction for real property taxes is not allowed in computing alternative minimum taxable income.[23]

<u>Limitation for 2018 through 2025</u>

Under Public Law 115-97,[24] the total amount of an individual taxpayer's deduction for State and local real property taxes, State and local personal property taxes, and State and local income, war profits, and excess profits taxes is limited to $10,000 ($5,000 for a married

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[20] Sec. 164(a)(1). In contrast with the deduction for mortgage interest, which is limited to interest in respect of an individual taxpayer's principal residence and one other residence, the deduction for real property taxes is allowed for taxes imposed on any number of an individual taxpayer's residences.

[21] Treas. Reg. sec. 1.164-3(b).

[22] Sec. 164(c)(1).

[23] Sec. 56(b)(1)(A).

[24] Sec. 11042.

individual filing a separate return) for a taxable year beginning after December 31, 2017 and before January 1, 2026.[25] This limitation does not apply to State and local real property taxes or personal property taxes paid or accrued in carrying on a trade or business or an activity described in section 212 (generally, an activity for the production or collection of income).[26]

Public Law 115-97 also limits the deduction for foreign real property taxes.[27] For taxable years beginning after December 31, 2017 and before January 1, 2026, an individual taxpayer may deduct foreign real property taxes (without regard to the $10,000 limitation) only if those taxes are paid or accrued in carrying on a trade or business or an activity described in section 212.[28] All foreign real property taxes may be deducted in taxable years beginning after December 31, 2025.[29]

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[25] Sec. 164(b)(6)(B).

[26] Sec. 164(b)(6). These taxes may, though, be subject to limitation under other rules including, for example, the section 469 passive loss rules.

[27] Sec. 11042.

[28] Sec. 164(a)(1), (b)(6).

[29] Sec. 164(a)(1), (b)(6)(A).

C. Exclusion of Gain from Sale of a Principal Residence

An individual taxpayer generally may exclude from gross income up to $250,000 (or, in the case of a married individual filing a joint return, up to $500,000) of gain realized on the sale or exchange of a principal residence.[30]

The exclusion is allowed in respect of an individual taxpayer's sale or exchange of a principal residence only if the taxpayer owned and used the residence as a principal residence for at least two years during the five-year period ending on the date of the sale or exchange. An individual taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or, to the extent provided under regulations, unforeseen circumstances is allowed an exclusion equal to the fraction of the otherwise applicable maximum ($500,000 for a married individual filing a joint return, or $250,000 for any other individual taxpayer) that is equal to the fraction of the two years during which the ownership and use requirements are met.

Under an election allowed to members of the uniformed services, the Foreign Service, certain employees of the intelligence community, and employees or volunteers of the Peace Corps, the five-year principal residence testing period that would otherwise end on the date of the sale or exchange of a principal residence may be suspended for any period up to 10 years during which the individual or the individual's spouse is on qualified official extended duty.

Gain from the sale or exchange of a principal residence allocated to periods of nonqualified use is not excluded from gross income. A period of nonqualified use means any period (not including any period before January 1, 2009) during which the property is not used by the individual or the individual's spouse or former spouse as a principal residence. For purposes of determining periods of nonqualified use, (1) any period after the last date on which the property is used as the principal residence of the individual or spouse (regardless of use during that period), and (2) any period (not to exceed two years) during which the individual is temporarily absent by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances, are not taken into account.

The amount of gain allocated to periods of nonqualified use is the amount of gain multiplied by a fraction, the numerator of which is the aggregate periods of nonqualified use during the period the property was owned by the individual taxpayer and the denominator of which is the period during which the individual taxpayer owned the property.

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[30] Sec. 121.

D. Tax-Exempt Bonds for Owner-Occupied Housing

In general

Gross income generally does not include interest received on State or local bonds. State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds which are primarily used to finance governmental functions or that are repaid with governmental funds. Private activity bonds are bonds with respect to which the State or local government serves as a conduit providing financing to nongovernmental persons (*e.g.*, private businesses or individuals). The exclusion from income for interest on State and local bonds only applies to private activity bonds if the bonds are issued for certain permitted purposes ("qualified private activity bonds"). Subject to certain requirements, qualified private activity bonds, including qualified mortgage bonds and qualified veterans' mortgage bonds ("mortgage revenue bonds"), may be issued to finance owner-occupied housing.[31]

Qualified mortgage bonds

Owner-occupied housing may be financed with the proceeds of qualified mortgage bonds.[32] Qualified mortgage bonds are tax-exempt bonds issued to make mortgage loans to eligible mortgagors for the purchase, improvement, or rehabilitation of owner-occupied housing for single-family principal residences (and certain two- to four-family residences). The Code imposes several limitations on qualified mortgage bonds, including income limitations for homebuyers, purchase price limitations for the homes financed with bond proceeds, a first-time homebuyer requirement, and a new mortgage requirement. The income limitations are satisfied if all the financing provided by an issue is provided for mortgagors (borrowers) whose family incomes do not exceed 115 percent (increased up to 140 percent for high housing cost areas) of the median family income for the metropolitan area or State, whichever is greater, in which the financed residences are located. The income limitations are modified for mortgagors having a family of fewer than three individuals. The purchase price limitations provide that a residence financed with qualified mortgage bonds may not have a purchase price in excess of 90 percent of the average area purchase price applicable for that residence.

In addition to these limitations, qualified mortgage bonds generally cannot be used to finance a mortgage for a homebuyer who had an ownership interest in a principal residence in the three years preceding the execution of the mortgage (the "first-time homebuyer" requirement). Under a special rule, qualified veterans' mortgage bonds (discussed in more detail below) may be issued, without regard to the first-time homebuyer requirement, to finance mortgages for veterans who served on active duty.

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[31] Sec. 143.

[32] Revenue Ruling 91-3, 1991-1 C.B. 31, describes typical financing structures involving qualified mortgage bonds. In one such structure, an individual taxpayer (A) applied to a private lending institution (X) for a Federally subsidized mortgage loan to finance the purchase of a principal residence located in city CI. X made the loan to A and subsequently sold the loan to CI under a preexisting agreement that was in place as of the date of the original loan issued by X to A. CI financed the purchase of the loan with the proceeds of qualified mortgage bonds.

Qualified mortgage bonds may be used only to finance original "new" mortgages (as contrasted with refinancing of existing mortgages). Limited exceptions allow refinancing of construction loans, bridge loans, and similar temporary initial financing.

The income and purchase price limitations are modified for residences in certain economically distressed areas ("targeted area residences"). A targeted area residence is one located in either (1) a census tract in which at least 70 percent of the families have incomes that are 80 percent or less of the State-wide median income or, (2) an area of chronic economic distress. Generally, at least 20 percent of the proceeds of a qualified mortgage issue must be made available for owner financing of targeted area residences for at least one year after the date on which owner financing is first made available with respect to targeted area residences. For targeted area residences, one-third of the mortgages may be made without regard to any income limits and the income limitations will be satisfied for the remaining two-thirds if made to mortgagors whose family income is 140 percent or less of the applicable median family income. The purchase price limitation is raised from 90 percent to 110 percent of the average area purchase price for targeted area residences. In addition, the first-time homebuyer requirement does not apply to targeted area residences.

Qualified mortgage bonds may be used to finance qualified home-improvement loans and qualified rehabilitation loans. Qualified home-improvement loans are defined as loans to finance alterations, repairs, and improvements on existing residences, but only if such alterations, repairs, and improvements substantially protect or improve the basic livability or energy efficiency of the properties. Qualified home-improvement loans generally may not exceed $15,000. Qualified rehabilitation loans are loans for rehabilitations of buildings at least 20 years old in which specified portions of the structure are retained and the rehabilitation expenditures represent at least 25 percent of the mortgagor's adjusted basis in the residence.

If the borrower experiences substantial increases in income and disposes of the subsidized residence within nine years after purchase, the borrower may be liable for a recapture tax. The amount of the tax depends on how long the mortgage was outstanding, the family income, and the amount of gain, if any, the borrower realizes on the sale.

Additional restrictions require spending the bond proceeds on eligible mortgages within 42 months after the issue date and applying mortgage loan repayments to redeem bonds (rather than to finance additional mortgages) starting 10 years after the issue date.

<u>Volume limitations on private activity bonds</u>

As with most qualified private activity bonds, issuance of qualified mortgage bonds is subject to annual State volume limitations (the "State volume cap"), which are indexed for inflation. For calendar year 2023, the unified State volume cap for all bonds which are subject to the limitation equals the greater of $120 per resident of the State or $358,845,000.[33]

[33] Rev. Proc. 2022-38, 2022-45 I.R.B. 445, p. 452.

Arbitrage limitations

Interest on a tax-exempt bond becomes taxable if the bond is an arbitrage bond. In general, an arbitrage bond is any bond if a portion of the bond proceeds are reasonably expected to be used directly or indirectly to acquire higher yielding investments or to replace funds that were used directly or indirectly to acquire higher yielding investments.[34]

In addition to the generally applicable arbitrage rules, mortgage revenue bonds (qualified mortgage bonds and qualified veterans' mortgage bonds) have additional restrictions. In the case of qualified mortgage bonds, the effective rate of interest on mortgage loans provided with an issue of qualified mortgage bonds may not exceed the yield on the issue by more than 1.125 percentage points. This determination is made on a composite basis for the issue rather than on a loan-by-loan basis. Additional rules apply in the case of qualified veterans' mortgage bonds, discussed below.

Mortgage credit certificates

Qualified governmental units can elect to exchange all or a portion of their qualified mortgage bond authority for authority to issue mortgage credit certificates ("MCCs").[35] MCCs entitle homebuyers to a nonrefundable income tax credit for a specified percentage of interest paid on mortgage loans on their principal residences. The tax credit provided by the MCC may be carried forward for three years. Once issued, an MCC generally remains in effect as long as the residence being financed is the certificate-recipient's principal residence. MCCs generally are subject to the same eligibility and targeted area requirements as qualified mortgage bonds.

Each MCC is required to represent a credit for at least 10 percent (but not more than 50 percent) of interest paid or incurred during the taxable year on qualifying mortgage indebtedness. The actual dollar amount of an MCC depends on the amount of qualifying interest paid during any particular year and the applicable certificate credit percentage. If the credit percentage exceeds 20 percent, however, the dollar amount of the credit received by the taxpayer for any year may not exceed $2,000. The three-year carryforward is not permitted for amounts in excess of $2,000. The recapture rules for qualified mortgage bonds also apply to MCCs if the homeowner experiences substantial increases in income and disposes of the subsidized residence within nine years of purchase.

When a homebuyer receives an MCC, the homebuyer's deduction for interest on the qualifying indebtedness is reduced by the amount of the credit. For example, a homebuyer receiving a 50-percent credit, and making $4,000 of qualifying mortgage interest payments in a given year, would receive a $2,000 credit and a deduction for the remaining $2,000 of interest payments (if the homebuyer itemizes deductions and subject to the limitations discussed above).

[34] A second type of general arbitrage limitation requires payment to the United States of certain excess earnings on nonpurpose investments over the yield on the tax-exempt bonds.

[35] Sec. 25.

The aggregate amount of MCCs distributed by an electing issuer cannot exceed 25 percent of the volume of qualified mortgage bond authority exchanged by the State or local government for authority to issue MCCs. For example, a State that was authorized to issue $200 million of qualified mortgage bonds, and that elected to exchange $100 million of that bond authority, could distribute an aggregate amount of MCCs equal to $25 million.

Qualified veterans' mortgage bonds

Qualified veterans' mortgage bonds are qualified private activity bonds the proceeds of which are used to make mortgage loans to qualified veterans. The Code imposes limitations on qualified veterans' mortgage bonds, including a veterans' residence requirement, a new mortgage requirement, arbitrage restrictions, and a requirement to secure the bonds through a general obligation pledge by the State. Authority to issue qualified veterans' mortgage bonds is limited to States that had issued such bonds before June 22, 1984. Qualified veterans' mortgage bonds are not subject to the State volume limitations generally applicable to private activity bonds. Instead, annual issuance in each State is subject to a separate State volume limitation. The five States eligible to issue these bonds are Alaska, California, Oregon, Texas, and Wisconsin.

Mortgage loans can be made to veterans who served on active duty and who applied for the financing before the date 25 years after the last date on which such veteran left active service.

The annual volume of qualified veterans' mortgage bonds that can be issued in California ($340 million) or Texas ($250 million) is based on the average amount of bonds issued in the respective State between 1979 and 1984. In Alaska, Oregon, and Wisconsin, the annual limit on qualified veterans' mortgage bonds that can be issued is $100 million each. Unused allocation cannot be carried forward to subsequent years.

E. Restrictions on Deductions for Business Use of Home and Rental of Home or Vacation Home

Section 280A generally prohibits any deductions with respect to a dwelling unit which is used by the taxpayer during the taxable year as a residence, unless specifically excepted and otherwise allowable. This applies to individuals and S corporations. The general disallowance provision, however, does not apply with respect to certain expenses which are otherwise allowable as deductions; for example, the deductions allowable for interest (sec. 163), certain taxes (sec. 164) and casualty losses (sec. 165) may still be claimed as deductions without regard to their connection with the taxpayer's trade or business or income-producing activities.[36]

For purposes of section 280A, the term "dwelling unit" includes a house, apartment, condominium, mobile home, boat, or similar property used as the taxpayer's home, and all structures or other property appurtenant to such dwelling unit (*e.g.*, an unattached garage).[37] Such term does not include that portion of a dwelling unit that is used exclusively as a hotel, motel, inn, or similar establishment.

Home office deduction

A taxpayer's business use of his or her home may give rise to a deduction for the business portion of expenses related to operating the home (*e.g.*, a portion of rent or depreciation and repairs). Section 280A(c)(1) provides, however, that business deductions generally are allowed only with respect to a portion of a home that is used exclusively and regularly in one of the following ways: (1) as the principal place of business for any trade or business of the taxpayer;[38] (2) as a place of business used to meet or deal with patients, clients, or customers in the normal course of the taxpayer's trade or business; or (3) in connection with the taxpayer's trade or business, if the portion so used constitutes a separate structure not attached to the dwelling unit. In the case of an employee, the business use of the home must be for the convenience of the employer.[39]

[36] Sec. 280A(b). An individual files Schedule A (Form 1040) to deduct interest, taxes, and casualty losses not related to his or her business or rental activity. However, Schedule A is only filed if the taxpayer is electing to itemize deductions in lieu of taking the standard deduction. The deductions that may be itemized include certain State and local income, property, and sales taxes (up to $10,000 annually ($5,000 for married taxpayers filing separately)), home mortgage interest (on mortgages up to certain specified dollar amounts), and casualty and theft losses attributable to Federally declared disasters (in excess of 10 percent of AGI and in excess of $100 per loss). Section 67(b) provides a list of allowable itemized deductions. All other itemized deductions ("miscellaneous itemized deductions") are suspended through 2025. Sec. 67(g).

[37] Sec. 280A(f)(1).

[38] A home office qualifies as the "principal place of business" if (1) the office is used by the taxpayer to conduct administrative or management activities of a trade or business, and (2) there is no other fixed location of the trade or business where the taxpayer conducts substantial administrative or management activities of such trade or business. Sec. 280A(c)(1) flush language.

[39] Sec. 280A(c)(1) flush language. If an employer provides access to suitable space on the employer's premises for the conduct by an employee of particular duties, then, if the employee opts to conduct such duties at

Section 280A(c)(2) contains a special rule that allows a home office deduction for business expenses related to a space within a home that is used on a regular (even if not exclusive) basis as a storage unit for the inventory or product samples of the taxpayer's trade or business of selling products at retail or wholesale, but only if the home is the sole fixed location of such trade or business.

The deductibility of expenses incurred for local transportation between a taxpayer's home and a work location sometimes depends on whether the taxpayer's home office qualifies under section 280A(c)(1) as a principal place of business.[40] In addition, no home office deduction is allowable by reason of business use where an employee leases a portion of his or her home to the employer.[41]

Daycare provider

A taxpayer may also be able to claim a deduction for part of the home used on a regular basis in the taxpayer's trade or business of providing daycare services, even if the same space is used for nonbusiness purposes.[42] In order to qualify for a home office deduction, (1) the business must provide daycare for children, people age 65 or older, or people who are physically or mentally unable to care for themselves; and (2) the business must have applied for, been granted, or be exempt from having a license, certification, registration, or approval as a daycare center or as a family or group daycare home under State law.

Rental of home or vacation home

Section 280A limits the amount allowable to a taxpayer for the deductions attributable to the rental of a dwelling unit if the taxpayer personally uses the dwelling unit in excess of specified periods of time during a taxable year. This limitation only applies if the taxpayer's use of the dwelling unit for personal purposes during his taxable year exceeds the greater of 14 days or 10 percent of the number of the days during the year for which the home is rented.[43] As discussed below, in the case where the taxpayer rents a dwelling unit used as a residence for less than 15 days, neither income nor loss is recognized for tax purposes.

For this purpose, a dwelling unit is not treated as rented (at a fair rental) for any day for which it is treated as used for personal purposes. In the case of a dwelling unit owned by an S corporation, the number of days of personal use by a taxpayer is determined by reference to the

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home as a matter of personal preference, the employee's use of the home office is not "for the convenience of the employer." See, *e.g.*, *Mathes v. Commissioner*, T.C. Memo 1990-483.

[40] See, *e.g.*, Rev. Rul. 99-7, 1999-5 I.R.B. 4.

[41] Sec. 280A(c)(6).

[42] Sec. 280A(c)(4).

[43] Sec. 280A(d)(1).

total number of days of personal use by the shareholders.[44] If a taxpayer owns a dwelling unit during only a portion of the taxable year, no reduction of the personal use specified under section 280A is required by reason that the dwelling unit is owned for less than a full year.

The taxpayer generally is deemed to have used a dwelling unit for personal purposes for a day if, for any part of the day, the unit is used (1) for personal purposes by the taxpayer or any other person who owns an interest in the home, or by their brothers and sisters, spouses, ancestors, or lineal descendants; (2) by any individual who uses the unit under a reciprocal arrangement (whether or not a fair rental is charged); or (3) by any other individual who uses the dwelling unit during a day unless for that day the unit is rented for a fair rental.[45] A taxpayer is not considered to have personally used a dwelling unit with respect to a use by his employee, even if it is rented for less than a fair rental, if the value of such use is excludable from income by the employee under section 119 (relating to meals and lodging furnished for the convenience of an employer). Further, if the taxpayer spends a normal work day cleaning, painting, repairing or otherwise maintaining the dwelling unit, such use is not treated as personal use.

In any case where there is any personal use of a dwelling unit during the taxpayer's taxable year (whether or not that personal use constitutes use as a residence), the expenses allocable to the rental of the vacation home are limited to an amount which bears the same ratio to such expenses as the number of days the unit is actually rented out for the year bears to the total number of days the unit is actually used for all purposes during the year.[46] However, the limitation upon allocable expenses does not apply to expenses such as home mortgage interest or property taxes which are otherwise allowable even if not attributable to the rental activity.

Exclusion for rental value of a residence rented for fewer than 15 days

Gross income generally includes all income from whatever source derived, including rents from real property.[47] Section 280A(g) provides a *de minimis* exception to this rule if a dwelling unit is used during the taxable year by the taxpayer as a residence and is rented for fewer than 15 days during the taxable year. In this case, the rental income is not included in gross income and no deductions attributable to such rental use are allowed. For example, assume that taxpayer A rents his residence for fewer than 15 days during the taxable year. Taxpayer A receives $5,000 in rent and has $2,000 of otherwise applicable deductions arising from such rental use. Under section 280A(g), none of the $2,000 is deductible and none of the $5,000 of rental income is included in gross income.

[44] Sec. 280A(f)(2).

[45] Sec. 280A(d)(2).

[46] Sec. 280A(e).

[47] Sec. 61(a).

Coordination with the hobby loss rules

Hobbies and other activities may resemble business activities although they are not intended to produce a profit. To preclude the claiming of tax losses from such activities to shelter other income, section 183 restricts deductions in respect of activities not engaged in for profit. Under this rule, if an activity is not engaged in for profit, allowable deductions are limited to those amounts which could be deducted without regard to the nature of the activity in which incurred (such as certain interest and taxes), plus other expenses in an amount not exceeding the income produced by the activity.[48] Section 183 presumes an activity to be engaged in for profit if the activity produces net income for any three or more taxable years in a period of five consecutive taxable years (the "five-year presumption").[49]

If section 280A applies with respect to any dwelling unit (or portion thereof) for a taxable year, the hobby loss limits of section 183 do not apply to the dwelling unit (or portion thereof) for such taxable year.[50] Such taxable year, however, is taken into account as a taxable year for purposes of applying the five-year presumption of section 183(d).

Determining the amount of allowable deductions under section 280A

Expenses attributable to the home office or rental use of the home may not exceed the excess of (A) the gross income derived from such use for the taxable year, over (B) the sum of (i) the deductions allocable to such use for the taxable year whether or not the home or portion thereof was so used, and (ii) the deductions allocable to the trade or business or rental activity in which such use occurs, but which are not allocable to such use, for such taxable year.[51] Thus, any otherwise allowable home office or rental deductions may not be claimed if they create (or increase) a net loss from a business or rental activity, although such deductions may be carried over to subsequent taxable years.[52] When a deduction for business or rental use of the taxpayer's residence is carried forward, such deduction continues to only be allowable up to the amount of income from the business or rental activity in which it arose, whether or not the dwelling unit is used as a residence during such taxable year.

[48] Sec. 183(b).

[49] Sec. 183(d).

[50] Sec. 280A(f)(3).

[51] Sec. 280A(c)(5). Note that any expense related to the first telephone line for the home is a nondeductible personal expense that is not allocable to any business use of the home. Sec. 262. The passive activity limitations of section 469 (discussed *infra*) do not apply to any activity for any taxable year in which the section 280A(c)(5) gross income limitation applies to the activity. Sec. 469(j)(10).

[52] A tiering system is used to determine which deductions carry forward. See Prop. Treas. Reg. Sec. 1.280A-2(i)(5); Form 8829, *Expenses for Business Use of Your Home*; IRS Publication 527, *Residential Rental Property (Including Rental of Vacation Homes)*; and IRS Publication 587, *Business Use of Your Home (Including Use by Daycare Providers)*.

Home office deduction safe harbor method

As an alternative to calculating, allocating, and substantiating the taxpayer's actual expenses of operating the home between personal and trade or business use, the Internal Revenue Service ("IRS") has provided an elective safe harbor method for taxpayers to calculate the amount of the home office deduction.[53] The safe harbor method is not available to determine the amount of the deductions allowed that are allocable to use of the home in a rental activity.[54]

Under the safe harbor method, a taxpayer uses a prescribed rate of $5 per square foot of the portion of the home used for the trade or business activity, up to a maximum of 300 square feet, to determine the amount of deductible expenses related to such use.[55] Thus, the maximum deduction under the safe harbor method is $1,500, not to exceed the gross income of the business reduced by business deductions unrelated to the qualified business use of the home (*e.g.*, advertising, wages, supplies, etc.).[56] Any amount in excess of this gross income limitation cannot be carried over and claimed as a deduction in any other taxable year.

A taxpayer electing the safe harbor method for a taxpayer year cannot deduct any actual expenses related to the qualified business use of the home for such taxable year (other than any otherwise allowable deductions such as mortgage interest and property taxes). Once made, the election is irrevocable, but may be made annually (*e.g.*, a taxpayer may elect the safe harbor method for 2022, but then calculate, allocate, and substantiate actual expenses for 2023).

Claiming allowable deductions

A sole proprietorship, like other businesses, is generally entitled to deduct its business expenses. For example, business expenses (including the home office deduction) are generally deductible by the sole proprietor without regard to whether the individual itemizes deductions.[57] On the other hand, an employee generally cannot deduct business expenses without itemizing deductions.[58] For employees who itemize, miscellaneous business deductions for unreimbursed employee business expenses are generally subject to the 2-percent-of-adjusted gross income

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[53] See Rev. Proc. 2013-13, 2013-6 I.R.B. 478.

[54] Sec. 3.02 of Rev. Proc. 2013-13.

[55] Sec. 4.01 of Rev. Proc. 2013-13.

[56] Sec. 4.08(2) of Rev. Proc. 2013-13.

[57] See Schedule C (Form 1040), *Profit or Loss from Business (Sole Proprietorship)*, and Form 8829, *Expenses for Business Use of Your Home*. In the case of a farmer who uses his or her home in a farming business, the deduction is reported on Schedule F (Form 1040), *Profit or Loss From Farming*.

[58] See Schedule A (Form 1040), *Itemized Deductions*.

floor on miscellaneous itemized deductions.[59] However, miscellaneous itemized deductions are suspended through 2025, and thus are not currently deductible.[60]

Allowable expenses related to the rental of the taxpayer's home or vacation home are generally reported on Schedule E (Form 1040), *Supplemental Income and Loss*. If income from the rental activity exceeds allowable rental expenses, the taxpayer may be subject to the net investment income tax.[61]

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[59] See sec. 67.

[60] Sec. 67(g).

[61] See sec. 1411.

F. Other Provisions

1. Qualified first-time homebuyer distributions

Distributions from a retirement plan received before the taxpayer is age 59 ½ are generally subject to a 10-percent additional tax.[62] This early distribution tax applies to distributions from qualified retirement plans (such as a section 401(k) plan), as well as section 403(b) plans and individual retirement annuities ("IRAs").[63] However, certain exceptions apply, including in the case of a qualified first-time homebuyer distribution.[64]

A qualified first-time homebuyer distribution is any payment or distribution (or portion thereof) from an IRA that is used to pay qualified acquisition costs of a principal residence of a first-time homebuyer.[65] The distribution must be used within 120 days. The first-time homebuyer may be the taxpayer, the taxpayer's spouse, or a child, grandchild, or ancestor of the taxpayer or the taxpayer's spouse. In order to qualify as a first-time homebuyer, the individual (and, if married, the individual's spouse) must not have had present ownership interest in a principal residence for the two-year period prior to acquiring the residence to which the qualified first-time homebuyer distribution applies.[66]

Qualified acquisition costs, for this purpose, mean the cost of acquiring, constructing, or reconstructing a residence. The term includes any usual or reasonable settlement, financing, or other closing costs. A lifetime dollar limit of $10,000 applies. If a distribution fails to qualify as a qualified first-time homebuyer distribution solely due to a delay or cancellation of the purchase or construction of the residence, the distribution may be contributed to an IRA and treated as a rollover contribution if such contribution is made within 120 days of distribution.[67]

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[62] Sec. 72(t).

[63] The 10-percent additional tax applies to qualified retirements plans (qualified under section 401(a)), section 403(b) plans, section 403(a) annuity plans, and IRAs. Secs. 72(t)(1), 4974(c).

[64] Sec. 72(t)(2)(F). Other exceptions include, for example, distributions to a beneficiary, distributions upon death or disability, distributions after separation from service after age 55, and distributions from IRAs for higher education expenses. Sec. 72(t)(2).

[65] Sec. 72(t)(8).

[66] The date of acquisition, for this purpose, is the date on which a binding contract to acquire the principal residence is entered into, or the date on which construction or reconstruction of the principal residence is commenced. Principal residence has the same meaning as under section 121 (relating to income exclusion of gain on the sale of principal residence).

[67] The distribution may be contributed as a rollover to an IRA as described in section 408(d)(3)(A)(i) (without regard to section 408(d)(3)(B)), except that the taxpayer may make such contribution within 120 days of distribution rather than within 60 days. Because such contribution is treated as a rollover, the distribution is not included in gross income. Additional time for the contribution may be available in the case of specified disasters. See, *e.g.,* the Consolidated Appropriations Act, 2021, Pub. L. No. 116-260, Division EE, sec. 302, December 27, 2020; and the Consolidated Appropriations Act, 2023, Pub. L. No. 117-328, Division T, the "SECURE 2.0 Act of 2022," sec. 331, December 29, 2022; Sec. 72(t)(8)(F).

2. Employer-sponsored retirement plan loans

Certain employer-sponsored retirement plans, including a section 401(a) qualified retirement plan, a section 403(a) annuity plan, a section 403(b) tax-sheltered annuity plan, and a governmental plan,[68] may provide loans to participants. Unless the loan satisfies certain requirements in both form and operation, the amount of a retirement plan loan made to a participant or beneficiary is a deemed distribution from the retirement plan.[69] First, the loan amount must not exceed the lesser of: (1) the greater of (a) 50 percent of the participant's account balance under the plan or (b) $10,000), or (2) $50,000 (generally taking into account outstanding balances of previous loans).[70] Second, the loan's terms must generally provide for a repayment period of not more than five years.[71] Third, level amortization of loan payments must be made not less frequently than quarterly.[72] A deemed distribution of an unpaid loan balance generally is taxed in the same manner as an actual distribution, including being subject to a 10-percent early distribution tax[73] (if an actual distribution would have been subject to the tax). A deemed distribution is not eligible for rollover to another eligible retirement plan. Subject to the limit on the amount of loans, which precludes any additional loan that would cause the limit to be exceeded, the rules relating to loans do not limit the number of loans an employee may obtain from a plan. A loan may not be made through the use of any credit card or any other similar arrangement.[74]

<u>Exemption for certain loans from the prohibited transaction rules</u>

Generally, the extension of a loan or credit between a plan and a disqualified person who is a participant (or beneficiary) of the plan is subject to excise taxes[75] on prohibited

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[68] A governmental plan means any plan, whether or not qualified, established and maintained for its employees by the United States, by a State or political subdivision thereof, or by an agency or instrumentality of any of the foregoing.

[69] Sec. 72(p)(1).

[70] Sec. 72(p)(2)(A). There are certain exceptions to this rule for loans, for example, individuals eligible to receive a coronavirus-related distribution under section 2202 of the Coronavirus Aid, Relief, and Economic Security Act, Pub. L. No. 116-136, March 27, 2020, may take a loan during a specified period of time equal to the lesser of the present value of the nonforfeitable accrued benefit of the employee under the plan or $100,000 (and certain other rules apply to such loans). Special rules for loans also apply for certain individuals impacted by specified disasters, see, *e.g.*, section 302 of Div. EE of the Consolidated Appropriations Act, 2021, Pub. L. No. 116-260, December 27, 2020 and section 331 of Division T of the Consolidated Appropriations Act, 2023, Pub. L. No. 117-328, December 29, 2022, the "SECURE 2.0 Act of 2022."

[71] Sec. 72(p)(2)(B).

[72] Sec. 72(p)(2)(C). Thus, if an employee stops making payments on a loan before the loan is repaid, a deemed distribution of the outstanding loan balance generally occurs.

[73] Sec. 72(t).

[74] Sec. 72(p)(2)(D).

[75] Sec. 4975(a).

transactions.[76] However, an exemption from the prohibited transaction rules applies for a plan loan that: (1) is available to all participants and beneficiaries on a reasonably equivalent basis; (2) is not made available to highly compensated employees[77] in amounts greater than the amounts made available to other employees; (3) is made in accordance with specific plan provisions governing plan loans; (4) bears a reasonable rate of interest; and (5) is adequately secured.[78]

Loan proceeds used to purchase a principal residence

A loan from an employer-sponsored retirement plan is exempt from the five-year period repayment rule if the proceeds of the loan are used to acquire any dwelling unit which, within a reasonable time, is to be used as the principal residence[79] of the participant (a "principal residence plan loan").[80] The reasonable time period is determined at the time the loan is made. A principal residence plan loan is not required to be secured by the dwelling unit that is to be used as the participant's principal residence. In determining whether a loan is treated as for the acquisition of a principal residence, the same tracing rules apply that apply in determining acquisition indebtedness for purposes of the rules disallowing a deduction for personal interest.[81] While a refinancing cannot qualify as a principal residence plan loan, a loan from an employer-sponsored retirement plan that is used to repay a loan from a third party qualifies as a principal residence plan loan if the plan loan would have qualified as a principal residence plan loan if the proceeds of that loan, rather than the proceeds of the loan from the third party, would have been treated as used to acquire the principal residence.

3. Exclusion from income of certain housing allowances and related deductions

Rental value of parsonages

A minister's housing allowance, known as a "parsonage allowance," is excluded from gross income. Specifically, a "minister of the gospel's" gross income does not include: (1) the rental value of a home furnished as part of the minister's compensation; or (2) the rental allowance paid as part of the minister's compensation, to the extent used to rent or provide a

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[76] Sec. 4975(c)(1)(B). A disqualified person is generally defined in section 4975(e)(2).

[77] As defined in section 414(q).

[78] Sec. 4975(d)(1). Section 408(b)(1) of the Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406 ("ERISA") contains a similar exemption from the prohibited transaction rules of ERISA for certain loans.

[79] As defined under section 121. See also Treas. Reg. sec. 1.121-1.

[80] Sec. 72(p)(2)(B)(ii).

[81] The tracing rules under section 163(h)(3)(B) apply for this purpose. See Treas. Reg. sec. 1.72(p)-1, Q & A-7.

home, and to the extent such allowance does not exceed the fair rental value of the home, including furnishings and appurtenances such as a garage, plus the cost of utilities.[82]

Despite the statutory language describing a "minister of the gospel," the parsonage allowance exclusion is not limited to Christian ministers.[83]

A parsonage allowance is generally includible in net earnings from self-employment for purposes of SECA.[84]

Military housing allowances

Qualified military benefits are not included in gross income.[85] Qualified military benefits include the basic allowance for housing authorized under the Federal statute governing pay and allowances for members of the uniformed services.[86]

Generally, a qualified military benefit is any allowance or in-kind benefit (other than personal use of a vehicle) that: (1) is received by any member or former member of the uniformed services of the United States or any dependent of such member by reason of such member's status or service as a member of such uniformed services; and (2) was excludable from gross income on September 9, 1986, under any provision of law, regulation, or administrative practice which was in effect on such date.[87] Generally, other than certain cost of living adjustments, no modification or adjustment of any qualified military benefit after September 9, 1986, is taken into account for purposes of this exclusion from gross income.[88]

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[82] Sec. 107.

[83] *Salkov v. Commissioner*, 46 T.C .190, 194 (1966). See also Rev. Proc. 2014-3, 2014-1 I.R.B. 111, sec. 3.01(16) (IRS will not rule on whether an individual is a "minister of the gospel" for Federal tax purposes).

[84] Sec. 1402(a)(8). However, the rental value of any parsonage or any parsonage allowance provided after the individual retires is excluded from net earnings from self-employment, whether or not excludable under section 107.

A parsonage allowance includible in net earnings from self-employment is earned income for purposes of the EITC. See sec. 32(c)(2). However, because the parsonage allowance is excluded from gross income, it is not earned income for purposes of the child tax credit. See sec. 24(d)(1)(B).

[85] Sec. 134.

[86] 37 U.S.C. sec. 403.

[87] Sec. 134(b)(1).

[88] Sec. 134(b)(2), (3).

<u>Deductibility of mortgage interest and taxes allocable to tax-free allowances for ministers and military personnel</u>

A homeowner generally may deduct interest paid or accrued on a mortgage on the home (on mortgages up to certain specified dollar amounts)[89] or real property taxes paid or accrued on the home[90] (if an election is made to itemize deductions in lieu of taking the standard deduction).[91]

Deductions for expenses allocable to tax-exempt income, such as expenses incurred in earning income on tax-exempt investments, are generally disallowed.[92]

An exception to the disallowance of deductions for expenses allocable to tax-exempt income applies with respect to parsonage allowances and military housing allowances.[93] The exception applies to an otherwise allocable deduction for interest paid on a mortgage, or real property taxes paid, on the home of the taxpayer in the case of (1) a parsonage allowance, or (2) a military housing allowance. Thus, an individual may claim an otherwise allowable deduction for mortgage interest or real property taxes notwithstanding the receipt of a tax-free parsonage or military housing allowance (*i.e.*, the individual does not have to reduce the deduction(s) based on the housing allowance received).

4. Exclusion from gross income of discharge of qualified principal residence indebtedness

<u>In general</u>

Gross income generally includes income that is realized by a debtor from the discharge of indebtedness.[94] This general rule includes exceptions for debtors in Title 11 bankruptcy cases, insolvent debtors, certain student loans, certain farm indebtedness, certain real property business indebtedness, and certain principal residence indebtedness.[95] When discharge of indebtedness income is excluded from gross income under an exception to the general rule, a taxpayer

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[89] Sec. 163(a), (h)(3).

[90] Sec. 164(a)(1). This deduction is limited to $10,000 annually ($5,000 for married taxpayers filing separately).

[91] See sec. 63.

[92] Sec. 265.

[93] Sec. 265(a)(6). See also Rev. Rul. 83-3, 1983-1 C.B. 72, modified by Rev. Rul. 87-32, 1987-1 C.B. 131 (holding, prior to the enactment of section 265(a)(6), that mortgage interest expense and real property tax expense allocable to a parsonage allowance are not deductible).

[94] Sec. 61(a)(11). A debt cancellation that constitutes a gift or bequest is not treated as income to the donee debtor. Sec. 102. However, the donor-lender may be subject to gift tax on amounts forgiven. Sec. 2511(a); Treas. Reg. sec. 25.2511-1(a).

[95] Sec. 108(a)(1).

generally is required to reduce certain tax attributes, including basis in property, by the amount of the discharge of indebtedness.[96]

Ordering rules govern the exclusions from gross income for discharge of indebtedness income.[97] The amount of income from the discharge of indebtedness that an insolvent debtor, not in Title 11 bankruptcy, may exclude from gross income is not permitted to exceed the amount by which the debtor is insolvent.[98] In the case of a discharge in bankruptcy or where the debtor is insolvent, any reduction in basis may not exceed the excess of the aggregate bases of properties held by the taxpayer immediately after the discharge over the aggregate of the liabilities of the taxpayer immediately after the discharge.[99] In such a case, any discharged debt in excess of this limitation reduces other tax attributes.

For all taxpayers, the amount of discharge of indebtedness income generally is equal to the difference between the adjusted issue price of the debt being cancelled and the amount used to satisfy the debt.[100] These rules generally apply to the exchange of an old obligation for a new obligation, including a modification of indebtedness that is treated as an exchange (a debt-for-debt exchange).[101]

Qualified principal residence indebtedness

Gross income does not include discharge of indebtedness income by reason of a discharge (in whole or in part) of qualified principal residence indebtedness either (i) before January 1, 2026, or (ii) subject to a written arrangement entered into prior to January 1, 2026.[102] Qualified principal residence indebtedness means acquisition indebtedness with respect to the taxpayer's principal residence.[103] Only $750,000 of indebtedness ($375,000 in the case of a married filing separate taxpayer) may be taken into account as qualified principal residence indebtedness.[104] Acquisition indebtedness with respect to a principal residence generally means indebtedness which is incurred in the acquisition, construction, or substantial improvement of the principal residence of the individual and is secured by the residence.[105] It also includes

[96] Secs. 108(b), (c)(1) and 1017.

[97] Sec. 108(a)(2).

[98] Sec. 108(a)(3).

[99] Sec. 1017(b)(2).

[100] See sec. 1001(b); Treas. Reg. sec. 1.1001-2.

[101] See Treas. Reg. sec. 1.1001-3.

[102] Sec. 108(a)(1)(E).

[103] Sec. 108(h)(2). Acquisition indebtedness has the meaning given by section 163(h)(3)(B).

[104] This limitation is the same as the limitation on indebtedness for purposes of the deduction on interest on qualified residence acquisition indebtedness, for taxable years beginning before January 1, 2026. See sec. 163(h)(3)(F)(i)(II).

[105] Sec. 163(h)(3)(B).

refinancing of such indebtedness to the extent the amount of the indebtedness resulting from such refinancing does not exceed the amount of the refinanced indebtedness.[106] For these purposes, the term "principal residence" has the same meaning as under section 121.[107]

If, immediately before the discharge, only a portion of a discharged indebtedness is qualified principal residence indebtedness, the exclusion applies only to so much of the amount discharged as exceeds the portion of the debt which is not qualified principal residence indebtedness. Thus, assume that a principal residence is secured by an indebtedness of $750,000, of which $450,000 is qualified principal residence indebtedness and $300,000 is not qualified principal residence indebtedness. If the residence is sold for $350,000 and $400,000 of debt is discharged, then only $100,000[108] of the amount discharged may be excluded from gross income under the qualified principal residence indebtedness exclusion.

The individual's basis in the principal residence is reduced by the amount excluded from income.[109]

The qualified principal residence indebtedness exclusion does not apply to a taxpayer in a Title 11 case; instead, the general exclusion rules apply.[110] In the case of an insolvent taxpayer not in a Title 11 case, the qualified principal residence indebtedness exclusion applies unless the taxpayer elects to have the general exclusion rules apply instead.[111]

The exclusion does not apply to the discharge of a loan if the discharge is on account of services performed for the lender or any other factor not directly related to a decline in the value of the residence or to the financial condition of the taxpayer.[112]

5. Treatment of tenant-stockholders of cooperative housing corporations

A cooperative housing corporation is an ownership structure under local law. In general, under this structure, a cooperative housing corporation owns residential real property. Owners of the cooperative housing corporation, known as tenant-stockholders, own shares in the corporation and a related proprietary lease, which entitles each owner to a occupy a unit in the property. The tenant shareholders pay fees to the cooperative housing corporation, which uses the fees for the care of the property.

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[106] *Ibid.*

[107] Sec. 108(h)(5).

[108] $400,000 minus $300,000.

[109] Sec. 108(h)(1).

[110] Sec. 108(b)(2)(A).

[111] Sec. 108(b)(2)(C).

[112] Sec. 108(h)(3).

The cooperative housing corporation includes the fees received in income, but may generally deduct real estate taxes, interest, maintenance and other costs as trade or business expenses.[113]

A tenant-stockholder is allowed a deduction for a portion of the fee paid to the cooperative housing corporation. The cooperative housing corporation must be a corporation (1) that has one class of stock, (2) each of the stockholders of which is entitled, solely by reason of ownership of stock in the corporation, to occupy a dwelling owned or leased by the cooperative, (3) no stockholder of which is entitled to receive any distribution not out of earnings and profits of the corporation, except on complete or partial liquidation of the corporation, and (4) that meets one of the following three requirements: (a) 80 percent or more of the corporation's gross income for that taxable year is derived from tenant-stockholders; (b) at all times during that taxable year 80 percent or more of the total square footage of the corporation's property is used or available for use by the tenant-stockholders for residential purposes or purposes ancillary to such residential use; or (c) 90 percent or more of the expenditures of the corporation paid or incurred during that taxable year are paid or incurred for the acquisition, construction, management, maintenance, or care of the corporation's property for the benefit of tenant-stockholders.[114]

A tenant-stockholder in a cooperative housing corporation is allowed a deduction for amounts paid or accrued to the cooperative housing corporation to the extent those amounts represent the tenant-stockholder's proportionate share of (1) real estate taxes[115] allowable as a deduction to the corporation which are paid or incurred by the corporation on the corporation's buildings or land on which such buildings are situated,[116] and (2) interest[117] allowable as a deduction to the corporation that is paid or incurred by the corporation on its indebtedness contracted in the acquisition, construction, alteration, rehabilitation, or maintenance of the corporation's buildings, or in the acquisition of the land on which such buildings are situated.[118]

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[113] See sec. 162.

[114] Sec. 216(b)(2).

[115] See sec. 164; see also sec. 164(b)(6) (limiting the amount of State and local taxes that may be deducted).

[116] Subject to the $10,000 ($5,000 if married filing separately) limitation under section 164(b)(6)(B), discussed *supra*. See IRS Info. Letter 2020-0010 (July 29, 2020), and Joint Committee on Taxation, *General Explanation of Public Law No. 115-97* (JCS-1-18), December 2018, p. 68.

[117] See sec. 163.

[118] See sec. 216(a).

G. Prior Law Homebuyer Credits

Congress has previously enacted two temporary Federal income tax credits for first-time homebuyers. There is no first-time homebuyer Federal income tax credit under present law.

1. First-time homebuyer credit for the District of Columbia

In general

One credit that existed under prior law was the first-time homebuyer credit for principal residences purchased in the District of Columbia.[119] The credit was effective for homes purchased on or after August 5, 1997.[120] Upon its enactment, the credit was available only for homes purchased before January 1, 2001.[121] However, the credit was extended multiple times,[122] before expiring for homes purchased after December 31, 2011.[123] The following describes the credit as in effect immediately prior to its expiration.

Under the provision, an individual who buys a principal residence in the District of Columbia qualifies for a Federal income tax credit equal to $5,000.[124] For married individuals filing a separate return, the amount of the credit is limited to $2,500.[125] Otherwise, the credit amount does not vary by filing status. If two or more individuals who are not married jointly purchase a principal residence, the amount of the credit, limited to $5,000, is to be allocated among such individuals as provided by the Secretary.[126] The credit amount cannot exceed the

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[119] Former sec. 1400C. The Taxpayer Relief Act of 1997, Public Law No. 105-34 (August 5, 1997), designated certain economically depressed census tracts within the District of Columbia as the "District of Columbia Enterprise Zone," or "DC Zone," within which businesses and individual residents were eligible for special tax incentives. One such tax incentive for individual residents was the credit for first-time homebuyers of a principal residence in the District of Columbia.

[120] Former sec. 1400C(i); see also Pub. L. No. 105-34, sec. 701(c) (enacted Aug. 5, 1997).

[121] Pub. L. No. 105-34, sec. 701(a).

[122] See Pub. L. No. 111-312, Sec. 754(d); Pub. L. No. 110-343, Div. C, Sec. 322(d)(1); Pub. L. No. 109-432, sec. 110(d)(1); Pub. L. No. 108-311, sec. 310(d); Pub. L. No. 106-544, sec. 63; Pub. L. No. 106-170, sec. 510; Pub. L. No. 105-206, sec. 6008(d)(5).

[123] Former sec. 1400C(i); see also Pub. L. No. 115-114, Div. U, sec. 401(d)(4) (Mar. 23, 2018) (repealing the credit as deadwood).

[124] Former sec. 1400C(a).

[125] Former sec. 1400C(e)(1)(A).

[126] Former sec. 1400C(e)(1)(B).

purchase price of the principal residence. The credit is nonrefundable.[127] The taxpayer may carry forward any credit in excess of income tax liability.[128]

The credit phases out for individual taxpayers with modified adjusted gross income ("AGI") between $70,000 and $90,000 ($110,000 and $130,000 for joint filers).[129] For purposes of the phaseout, modified AGI is AGI increased by any amount excluded from gross income under section 911, 931, or 933.[130]

Definitions and limitations

A "first-time homebuyer" means any individual if such individual (and, if married, such individual's spouse) does not have a present ownership interest in a principal residence in the District of Columbia during the one-year period ending on the date of the purchase of the principal residence to which the credit applies.[131] A taxpayer may be treated as a first-time homebuyer with respect to only one residence[132]—*i.e.*, a taxpayer may claim the credit only once. The term "principal residence" has the same meaning as when used in section 121.[133]

The term "purchase"[134] means any acquisition other than (1) an acquisition from a related person;[135] (2) an acquisition for which the transferee's basis is determined by reference to the transferor's basis;[136] or (3) an acquisition from a decedent.[137] A residence constructed by the taxpayer is treated as purchased by the taxpayer on the date the taxpayer first occupies such residence.[138] The term "purchase price" means the adjusted basis of the principal residence on

[127] Former sec. 1400C(g)

[128] Former sec. 1400C(d).

[129] Former sec. 1400C(b)(1).

[130] Former sec. 1400C(b)(2).

[131] Former sec. 1400C(c)(1).

[132] Former sec. 1400C(c)(2).

[133] Former sec. 1400C(c)(3).

[134] See former sec. 1400C(e)(2)(A).

[135] Specifically, the exclusion applies to a transferor whose relationship to the transferee would cause a loss disallowance under section 267(B) or 707(b). Former sec. 1400C(e)(2)(A)(ii). However, for purposes of this rule, the definition of "member of a family" is treated as including only the taxpayer's spouse, ancestors, and lineal descendants, and not the taxpayer's siblings. *Ibid*.

[136] Thus, for example, an acquisition by gift is excluded. See sec. 1015(a).

[137] As described under section 1014(a).

[138] Former sec. 1400C(e)(2)(B).

the date such residence is purchased.[139] A taxpayer's basis in a property is reduced by the amount of the credit claimed with respect to such property.[140]

A taxpayer claiming the national first-time homebuyer credit (described immediately below) may not claim the District of Columbia first-time homebuyer credit.[141]

2. National first-time homebuyer credit

In general

Subsequent to the enactment of the District of Columbia first-time homebuyer credit (described immediately above), Congress enacted a temporary first-time homebuyer credit that was not limited to the purchase of a principal residence within a certain area or State, but rather was generally available to first-time homebuyers of a principal residence anywhere in the United States.[142] The credit was effective for homes purchased on or after April 9, 2008, in taxable years ending after that date.[143] Upon its enactment, the credit was available only for homes purchased before July 1, 2009.[144] However, the credit was extended twice,[145] before generally expiring for homes purchased on or after May 1, 2010.[146] The following describes the credit as in effect immediately prior to its expiration.

Under the provision, an individual who is a first-time homebuyer is allowed a Federal income tax credit equal to the lesser of $8,000 ($4,000 for a married individual filing separately) or 10 percent of the purchase price of a principal residence.[147] If two or more individuals who are not married jointly purchased a principal residence, the amount of the credit, limited to

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[139] Former sec. 1400C(e)(3).

[140] Former sec. 1400C(h). The provision also provided that if the Secretary required information reporting with respect to the credit under section 6045, the exception for the sale or exchange of certain principal residences under section 6045(e)(5) would not apply. Former sec. 1400C(f).

[141] Former sec. 1400C(e)(4).

[142] Sec. 36.

[143] Former Pub. L. No. 110-289, sec. 3011(a).

[144] Sec. 36(h), as enacted by Pub. L. 110-289, sec. 3011(a).

[145] See Pub. L. 111-92, sec. 11(a)(1)(A); P.L. 111-5, sec. 1006(a)(1).

[146] Sec. 36(h)(1). However, if a taxpayer had entered into a written binding contract before May 1, 2010, to close on the purchase of a principal residence before July 1, 2020, and purchased such residence, before October 1, 2010, the purchase would qualify for the credit. Sec. 36(h)(2).

While the credit has expired, some taxpayers may still be subject to the recapture provisions, described further below. The credit, unlike the first-time homebuyer credit for the District of Columbia, has not been repealed and remains in the Code.

[147] Sec. 36(a), (b)(1)(A), (b)(1)(B).

$8,000, is to be allocated among such individuals as provided by the Secretary.[148] The credit is refundable.[149]

The credit phases out for individual taxpayers with modified AGI between $125,000 and $145,000 ($225,000 and $245,000 for joint filers).[150] For purposes of the phaseout, modified AGI is AGI increased by any amount excluded from gross income under section 911, 931, or 933.[151]

Definitions and limitations

A "first-time homebuyer" means any individual if such individual (and, if married, such individual's spouse) does not have a present ownership interest in a principal residence during the three-year period ending on the date of the purchase of the principal residence to which the credit applies.[152] However, an exception applies to an individual (and, if married, the individual's spouse) who has maintained the same principal residence for any five-consecutive year period during the eight-year period ending on the date of the purchase of a subsequent principal residence, under which the individual is treated as a first-time homebuyer for the purchase of the subsequent residence.[153] Thus, the individual may claim the credit with respect to the subsequent residence. However, for taxpayers claiming the credit under this rule, the maximum allowable credit for such taxpayers is $6,500 ($3,250 for a married individual filing separately).[154]

The term "principal residence" has the same meaning as when used in section 121.[155]

The term "purchase"[156] means any acquisition other than (1) an acquisition from a related person;[157] (2) an acquisition for which the transferee's basis is determined by reference to the

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[148] Sec. 36(b)(1)(C). See also Notice 2009-12, 2009-6 I.R.B. 446 (allowing taxpayers to provide any reasonable method and providing examples).

[149] Sec. 6401(b) (treating the credits allowable by subpart C of part IV of subchapter A of chapter 1 as overpayments of tax); see also Sec. 6402.

[150] Sec. 36(b)(2)(A).

[151] Sec. 36(b)(2)(B).

[152] Sec. 36(c)(1).

[153] Sec. 36(c)(6).

[154] Sec. 36(b)(1)(D).

[155] Sec. 36(c)(2).

[156] See 36(c)(3)(A).

[157] Specifically, the exclusion applies to a transferor whose relationship to the transferee would cause a loss disallowance under section 267(B) or 707(b). Sec. 36(c)(5). However, for purposes of this rule, the definition of

transferor's basis;[158] or (3) an acquisition from a decedent.[159] A residence constructed by the taxpayer is treated as purchased by the taxpayer on the date the taxpayer first occupies such residence.[160] The term "purchase price"' means the adjusted basis of the principal residence on the date such residence is purchased.[161]

No credit is allowed for the purchase of any residence if the purchase price exceeds $800,000.[162]

No credit is allowed unless the taxpayer is 18 years of age as of the date of purchase.[163] A taxpayer who is married is treated as meeting the age requirement if the taxpayer or the taxpayer's spouse meets the age requirement.[164]

No credit is allowed for a taxable year if (1) the taxpayer is a nonresident alien; (2) the taxpayer is a dependent of another taxpayer; or (3) the taxpayer fails to attach to the relevant tax return a properly executed copy of the settlement statement used to complete the purchase.[165] Additionally, if the individual sells the residence (or the residence ceases to be used as the principal residence of the individual and the individual's spouse) in the same taxable year in which the residence is purchased, no credit is allowed.[166]

In the case of a purchase of a principal residence after December 31, 2008, a taxpayer is able to elect to treat the purchase as made on December 31 of the calendar year preceding the purchase for purposes of claiming the credit on the prior year's income tax return.[167] Thus, for example, an individual purchasing a house in 2009 may claim the credit on the individual's 2008 income tax return.

"member of a family" is treated as including only the taxpayer's spouse, ancestors, and lineal descendants, and not the taxpayer's siblings. *Ibid*.

[158] Thus, for example, an acquisition by gift is excluded. See sec. 1015(a).

[159] As described under section 1014(a).

[160] Sec. 36(c)(3)(B).

[161] Sec. 36(c)(4). The provision also provides that if the Secretary requires information reporting with respect to the credit under section 6045, the exception for the sale or exchange of certain principal residences under section 6045(e)(5) does not apply. Sec. 36(e).

[162] Sec. 36(b)(3).

[163] Sec. 36(b)(4).

[164] *Ibid*. For purposes of this rule, the definition of "marriage" in section 7703 applies.

[165] Sec. 36(d)(1), (3), (4).

[166] Sec. 36(d)(2).

[167] Sec. 36(g).

A taxpayer claiming the credit may not claim the District of Columbia first-time homebuyer credit (described immediately above).[168]

Recapture

For homes purchased on or before December 31, 2008, the credit is recaptured ratably over fifteen years, with no interest charge, beginning in the second taxable year after the taxable year in which the home is purchased.[169]

For example, if an individual purchases a home in 2008, recapture generally commences with the 2010 income tax return and generally continues through 2024. If the individual sells the home (or the home ceases to be used as the principal residence of the individual or the individual's spouse) prior to complete recapture of the credit, the amount of any credit not previously recaptured is due on the tax return for the year in which the home is sold (or ceases to be used as the principal residence).[170] However, in the case of a sale to an unrelated person, the amount recaptured may not exceed the amount of gain from the sale of the residence.[171] For this purpose, gain is determined by reducing the basis of the residence by the amount of the credit to the extent not previously recaptured.[172]

If the taxpayer claiming the credit dies, no additional recapture is generally required.[173] 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.[174] In the case of a transfer of the residence to a spouse or to a former spouse incident to divorce, the transferee spouse (and not the transferor spouse) is responsible for any future recapture.[175]

[168] Former sec. 1400C(e)(4).

[169] Sec. 36(f)(1), (4)(D), (7).

[170] Sec. 36(f)(2). If the individual sells the home (or the home ceases to be used as the principal residence of the individual and the individual's spouse) in the same taxable year the home is purchased, no credit is allowed. Sec. 36(d)(2).

[171] Sec. 36(f)(3).

[172] *Ibid.*

[173] Sec. 36(f)(4)(A). If the credit was previously claimed on a joint return, then the surviving spouse is required to continue repaying his or her half of the credit if none of the other exceptions apply.

[174] Sec. 36(f)(4)(B).

[175] Sec. 36(f)(4)(C).

For purposes of the recapture provision, in the case of married filing jointly taxpayers claiming the credit, half of the credit is treated as allowed to each spouse.[176] A taxpayer subject to recapture has to file an income tax return for any year in which the credit is recaptured.[177]

For homes purchased after December 31, 2008, the credit is recaptured only if the taxpayer disposes of the home (or the home otherwise ceases to be the principal residence of the taxpayer) within 36 months from the date of purchase.[178] These more limited recapture rules also apply to principal residences purchased after December 31, 2008, that are treated (at the election of the taxpayer) as purchased on December 31, 2008.[179]

Taxpayers on qualified official extended duty outside the United States

Certain more generous rules apply to taxpayers on qualified official extended duty outside the United States.

First, if the taxpayer serves on qualified official extended duty service[180] outside the United States for at least 90 days during the period beginning after December 31, 2008, and ending before May 1, 2010, the expiration date of the credit is extended one year to May 1, 2011.[181]

In addition, in the case of a disposition of principal residence by a taxpayer (or a cessation of use of the residence that otherwise would cause recapture) after December 31, 2008, in connection with Government orders received by the taxpayer (or the taxpayer's spouse) for qualified official extended duty service,[182] the credit is allowable even if the taxpayer disposes of the residence in the year of purchase.[183] For these taxpayers, no recapture applied by reason of

[176] Sec. 36(f)(5).

[177] Sec. 36(f)(6).

[178] Sec. 36(f)(4)(D).

[179] Sec. 36(g).

[180] As defined in section 121(d)(9)(C)(i).

[181] Sec. 36(h)(3)(A). In addition, for these taxpayers, the binding-contract exception is generally extended for one year—*i.e.*, the contract must be entered into before May 1, 2011, for a close and purchase before July 1, 2011. Sec. 36(h)(3)(B).

[182] For purposes of these rules, qualified official extended duty service means service on official extended duty as a member of the uniformed services, a member of the Foreign Service of the United States, or an employee of the intelligence community. Sec. 36(f)(4)(E)(ii). Terms used under both section 36(f)(4)(E)(ii) and section 121(d)(9) have the same meaning as under section 121(d)(9). Sec. 36(f)(4)(E)(iii).

[183] Sec. 36(f)(4)(E)(i).

the disposition of the residence, and any 15-year recapture with respect to a home acquired before January 1, 2009, ceases to apply in the taxable year the disposition occurs.[184]

[184] *Ibid.*

II. TAX PROVISIONS FOR RENTAL HOUSING

A. Low-Income Housing Tax Credit

A taxpayer may claim the low-income housing tax credit annually over a 10-year period for the costs of building or rehabilitating rental housing occupied by low-income tenants. The amount of credit that may be claimed each year is an amount equal to the applicable percentage of the qualified basis of each qualified low-income building.[185]

Credit calculations

The applicable percentage for non-Federally subsidized newly constructed housing and non-Federally subsidized substantial rehabilitation is calculated such that the present value of the 10 annual credit amounts equals 70 percent of a building's qualified basis.[186] The applicable percentage is adjusted monthly by the IRS on a discounted after-tax basis (assuming a 28-percent tax rate) based on the average of the annual applicable Federal rate ("AFR") for mid-term and long-term obligations for the month the building is placed in service.[187] However, under the Housing and Economic Recovery Act of 2008,[188] the minimum applicable percentage for such credits was temporarily set at nine percent. The Consolidated Appropriations Act, 2016[189] made the nine-percent minimum applicable rate permanent. These credits are sometimes referred to as "nine-percent credits."

The applicable percentage for Federally subsidized newly constructed housing, Federally subsidized substantial rehabilitation, and certain housing acquisition costs is calculated such that the present value of the 10 annual credit amounts equals 30 percent of a building's qualified basis. The applicable percentage is adjusted monthly by the IRS on a discounted after-tax basis (assuming a 28-percent tax rate) based on the average of the annual AFR for mid-term and long-term obligations for the month the building is placed in service. However, under the

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[185] Sec. 42(a).

[186] See sec. 42(b)(1)(B) and (e).

[187] For February 2023, 72 percent of the average of the AFR for mid-term and long-term obligations based on annual compounding is 2.76 percent. The appropriate percentage for determining the amount of the 70 percent present value credit is 7.89 percent, and the appropriate percentage for determining the amount of the 30 percent present value credit is 3.38 percent. However, because of the minimum applicable percentages in effect, the actual percentages are nine percent and four percent, respectively. The minimum nine-percent applicable percentage results in a stream of low-income housing tax credits with a present value equal to approximately 80 percent of a building's qualified basis. The minimum four-percent applicable percentage results in a stream of low-income housing tax credits with a present value equal to approximately 35 percent of a building's qualified basis. Rev. Rul. 2023-3, 2023-6 I.R.B. 1, January 17, 2023, and Joint Committee staff calculations.

[188] Pub. L. No. 110-289, July 30, 2008.

[189] Pub. L. No. 114-113, December 18, 2015.

Consolidated Appropriations Act, 2021,[190] the minimum applicable percentage for such credits was set at four percent. These credits are sometimes referred to as "four-percent credits."

Generally, buildings located in certain census tracts and difficult development areas, as designated by the Secretary of Housing and Urban Development, are eligible for increased housing credit.[191] The increase in housing credit is effectuated by increasing a building's eligible basis from 100 to 130 percent of the otherwise applicable eligible basis (in the case of a new building) or rehabilitation expenditures (in the case of an existing building). A building designated by a State housing credit agency as requiring an increase in credit in order to be financially feasible is treated as being located in a difficult development area.

State housing credit ceiling

Generally, the low-income housing tax credit is allowable only if the taxpayer receives a housing credit allocation from a State or local housing credit agency. The aggregate credit authority provided annually to each State for calendar year 2023 is $2.75 multiplied by the State population, with a minimum annual credit amount of $3,185,000 for certain small population States.[192] The amount of housing credit allocated to a low-income building reduces the State housing credit ceiling only once, in the year the housing credit is allocated. For example, $100 of allocated credits equates to $100 of credits annually for a period of 10 years, or a total of $1,000 of credits. However, credit allocations are not needed for buildings that receive 50 percent or more of their financing from the proceeds of tax-exempt bonds that are subject to the private activity bond volume limit, which are discussed further in section II.C of this document.[193]

Qualified low-income housing projects and qualified low-income buildings

A qualified low-income building is a building that is subject to a 15-year compliance period and is part of a qualified low-income housing project. A qualified low-income housing project is a project that meets the minimum set-aside requirement and other requirements with respect to the set-aside units at all times during the 15-year compliance period. Generally,

[190] Pub. L. No. 117-103, March 15, 2022.

[191] Sec. 42(d)(5).

[192] See Rev. Proc. 2022-38, 2022-45 I.R.B. 445, October 18, 2022. For calendar years 2018, 2019, 2020, and 2021, the State housing credit ceiling was increased by multiplying the State housing credit ceiling amount by 1.125. Sec. 42(h)(3)(I). For calendar year 2022, the small population States were Alaska, Delaware, the District of Columbia, Montana, North Dakota, Rhode Island, South Dakota, Vermont, and Wyoming. See Notice 2022-12, 2022-12 I.R.B. 906, March 18, 2022.

[193] Sec 42(h)(4)(B). If less than 50 percent of a building is financed with tax-exempt bonds, only the portion of credits attributable to the bond-financed portion of the building is allowed without allocation. Sec. 42(h)(4)(A).

buildings are also subject to a 15-year extended-use period following the 15-year compliance period, during which time the buildings remain subject to housing affordability restrictions.[194]

Minimum set-aside requirement

To meet the minimum set-aside requirement, a qualified low-income housing project must satisfy one of three tests (whichever is elected by the taxpayer):[195]

- 20-50 test. The 20-50 test is met if 20 percent or more of the residential units in the project are both rent-restricted and occupied by tenants whose income is 50 percent or less of area median gross income.[196]
- 40-60 test. The 40-60 test is met if 40 percent or more of the residential units in such project are both rent-restricted and occupied by tenants whose income is 60 percent or less of area median gross income.
- Average income test. The average income test is met if 40 percent or more (25 percent or more in the case of a project located in a high-cost housing area) of the residential units in such project are both rent-restricted and occupied by tenants whose income does not exceed the imputed income limitation designated by the taxpayer with respect to the respective unit. The imputed income limitation is determined in 10-percentage-point increments, and may be designated as 20, 30, 40, 50, 60, 70, or 80 percent. The average of the imputed income limitations designated must not exceed 60 percent of area median gross income.[197]

Placed-in-service rules

Generally, a building must be placed in service in the calendar year in which it is allocated credits (the "allocation year").[198] However, many buildings are not sufficiently completed to be placed in service in the allocation year and require a carryover allocation to allow them to qualify for credits in a subsequent year. To qualify for a carryover allocation, the taxpayer must spend more than 10 percent of the taxpayer's reasonably expected basis in the building (as of the close of the second calendar year following the allocation year) within one

[194] See sec. 42(h)(6).

[195] Sec. 42(g)(1). Nationally, a majority of new units satisfy the minimum set-aside requirement using the 40-60 test, but from 2019 to 2021, an increasing share of new units have used the average income test. In 2019, 84.4 percent of new units used the 40-60 test and only 10.1 percent of new units used the average income test. In 2021, 78.1 percent of new units used the 40-60 test and 14.4 percent of new units used the average income test. NCSHA, HFA Factbook: 2021 Annual Survey Results, Table 9.

[196] Area median gross income is adjusted for family size and based on annual estimates produced by the Department of Housing and Urban Development. Notice 88-80, 1988-30 I.R.B. 28, July 25, 1988.

[197] Treas. Reg. secs. 1.42-15 and 1.42-19; T.D. 9967, 87 Fed. Reg. 61489, October 12, 2022.

[198] Sec. 42(h)(1)(B).

year of the date that the allocation was made.[199] Such building generally must be placed in service by the end of the second calendar year following the allocation year.

The IRS defines the placed-in-service date for new or existing buildings as "the date on which the building is ready and available for its specifically assigned function, *i.e.*, the date on which the first unit in the building is suitable for occupancy in accordance with [S]tate or local law."[200] Certain rehabilitation expenditures, which are treated as separate new buildings for purposes of the credit, are treated as placed in service at the end of any 24-month period over which the expenditures are incurred.[201]

Qualified allocation plans

The low-income housing tax credit must be allocated pursuant to a housing credit agency's qualified allocation plan ("QAP").[202] A QAP is defined as any plan that (1) sets forth the selection criteria to be used to determine the housing priorities of the housing credit agency which are appropriate to local conditions, (2) which give preference in allocating housing credit to certain projects (*e.g.*, projects serving the lowest income tenants), and (3) which provide a procedure that the agency will follow in monitoring for noncompliance and in notifying the IRS of such noncompliance and in monitoring for noncompliance with habitability standards through regular site visits.[203] QAPs must include the following selection criteria: project location, housing needs characteristics, project characteristics, sponsor characteristics, tenant populations with special housing needs, public housing waiting lists, tenant populations of individuals with children, projects intended for eventual tenant ownership, the energy efficiency of the project, and the historic nature of the project.[204]

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[199] Sec. 42(h)(1)(E).

[200] See Notice 88-116, 1988-2 C.B. 44.

[201] Sec. 42(e)(4)(A).

[202] Sec. 42(m).

[203] Sec. 42(m)(1)(B).

[204] Sec. 42(m)(1)(C).

B. Rehabilitation Tax Credit

A 20-percent tax credit is provided for qualified rehabilitation expenditures with respect to a certified historic structure that has been substantially rehabilitated, for which depreciation or amortization is allowable, and that meets other requirements to be a qualified rehabilitated building.[205] The credit is generally allowable ratably in each taxable year over the five-year period beginning in the taxable year in which the qualified rehabilitated building is placed in service, for amounts paid or incurred after December 31, 2017.[206]

The basis of the property is reduced by the amount of the rehabilitation credit.[207]

A certified historic structure means any building that is listed in the National Register, or that is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.

For qualified rehabilitation expenditures to be eligible for the credit, the building must be substantially rehabilitated. A building is treated as having met the substantial rehabilitation requirement only if the rehabilitation expenditures during the 24-month period selected by the taxpayer and ending within the taxable year exceed the greater of (1) the adjusted basis of the building (and its structural components), or (2) $5,000.[208] Taxpayers are required to use straight-line depreciation or in certain circumstances the alternative depreciation method in order for rehabilitation expenditures to be treated as qualified.

Qualified rehabilitation expenditures with respect to residential property generally do not include any expenditure in connection with the rehabilitation of the portion of a building that is (or is expected to be) leased to a tax-exempt entity.[209] In the case of nonresidential real property, qualified rehabilitation expenditures generally do not include any expenditure in connection with the rehabilitation of a building that is more than 50 percent leased to a tax-exempt entity in a disqualified lease. In general, a disqualified lease includes a lease of tax-exempt-bond-financed

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[205] Sec. 47. A qualified rehabilitated building is defined in section 47(c)(1).

[206] Sec. 47(b). The provision was modified by section 13402 of Pub. L. No 115-97 (enacted December 22, 2017) generally to repeal the prior-law credit for pre-1936 buildings, and to provide that the 20-percent credit for qualified rehabilitation expenditures in the case of a certified historic building is allowable ratably over a five-year period for amounts paid or incurred after December 31, 2017. A transition rule with respect to the credit allowable under prior law with respect to any building owned or leased (as provided under prior law) by the taxpayer at all times on or after January 1, 2018, provides that the 24-month period selected by the taxpayer (or the 60-month period selected by the taxpayer under the rule for phased rehabilitation) begins not later than the end of the 180-day period beginning on the date of enactment (December 22, 2017), and the amendments made by the provision apply to such expenditures paid or incurred after the end of the taxable year in which such 24-month (or 60-month) period ends.

[207] Sec. 50(c). The amount of the basis reduction is the full amount of the credit. See Treas. Reg. secs. 1.47-7(d) and 1.47-7(e), example 2.

[208] Sec. 47(c)(1)(B). A special rule for phased rehabilitation substitutes a 60-month period for the 24-month period. Sec. 47(c)(1)(B)(ii).

[209] Secs. 47(c)(2)(B)(v) and 168(h).

property, a lease with a sale option (or its equivalent) to the tax-exempt entity, a lease with a term greater than 20 years, or a sale-leaseback arrangement involving a tax-exempt entity.[210] For this purpose, a tax-exempt entity generally includes the United States, a state or political subdivision, possession, or any agency or instrumentality of the foregoing ("governmental entity").[211]

A recapture rule applies if the credit property is disposed of, or otherwise ceases to be credit property with respect to the taxpayer, within a five-year recapture period after the property is placed in service.[212]

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[210] Sec. 168(h)(1)(B).

[211] Sec. 168(h)(2). Certain exceptions also apply.

[212] Sec. 50(a).

C. Tax-Exempt Bond Financing for Residential Rental Property

In general

Private activity bonds are bonds with respect to which the State or local government serves as a conduit providing financing to nongovernmental persons (*e.g*., private businesses or individuals). The exclusion from income for interest paid on State and local bonds does not apply to private activity bonds unless the bonds are issued for certain permitted purposes ("qualified private activity bonds"). The definition of a qualified private activity bond includes, but is not limited to, bonds for qualified residential rental projects.

Qualified residential rental projects

Residential rental property may be financed with qualified private activity bonds if the financed project is a "qualified residential rental project."[213] A project is a qualified residential rental project if 20 percent or more of the residential units in such project are occupied by individuals whose income is 50 percent or less of area median gross income (the "20-50 test"). Alternatively, a project is a qualified residential rental project if 40 percent or more of the residential units in such project are occupied by individuals whose income is 60 percent or less of area median gross income (the "40-60 test"). The issuer must elect to apply either the 20-50 test or the 40-60 test. Operators of a qualified residential rental project must annually certify that such project meets the requirements for qualification, including meeting the 20-50 test or the 40-60 test.

As with most qualified private activity bonds, bonds for qualified residential rental projects are subject to annual State volume limitations (the "State volume cap"), which are indexed for inflation. For calendar year 2023, the unified State volume cap for all bonds which are subject to the limitation equals the greater of $120 per resident of the State or $358,845,000.[214]

Bonds issued to finance qualified residential rental projects are subject to a term to maturity rule which limits the period of time such bonds may remain outstanding. Generally, this rule provides that the average maturity of a qualified private activity bond cannot exceed 120 percent of the economic life of the property being financed.

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[213] Sec. 142(d). Qualified private activity bonds for qualified residential rental projects often are issued for projects for which taxpayers also claim the low-income housing tax credit, discussed above in Part II.A.

[214] Rev. Proc. 2022-38, 2022-45 I.R.B. 445, p. 452.

D. Accelerated Depreciation for Residential Rental Property

Depreciation in general

A taxpayer generally must capitalize the cost of property used in a trade or business or held for the production of income and recover such cost over time through annual deductions for depreciation or amortization.[215] The period for depreciation or amortization generally begins when the asset is placed in service by the taxpayer.[216] Tangible property generally is depreciated under the modified accelerated cost recovery system ("MACRS"), which determines depreciation for different types of property based on an assigned applicable depreciation method, recovery period, and placed in service convention.[217]

Real property

Recovery period and depreciation method

The applicable recovery period for an asset is determined in part by statute[218] and in part by historic Treasury guidance.[219] The "type of property" of an asset is used to determine the "class life" of the asset, which in turn dictates the applicable recovery period for the asset. The recovery periods for most real property are 39 years for nonresidential real property and 27.5 years for residential rental property.[220] The straight line depreciation method is required for the aforementioned real property.[221]

For depreciation purposes, residential rental property is defined as a building or structure with respect to which 80 percent or more of the gross rental income is rental income from dwelling units.[222] The term "dwelling unit" means a house or apartment used to provide living accommodations, but does not include a unit in a hotel, motel or other establishment more than

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[215] See secs. 263(a) and 167 (and the regulations thereunder). In general, only the tax owner of property (*i.e.*, the taxpayer with the benefits and burdens of ownership) is entitled to claim tax benefits such as cost recovery deductions with respect to the property. In addition, where property is not used exclusively in a taxpayer's business, the amount eligible for a deduction must be reduced by the amount related to personal use. See, *e.g.*, sec. 280A.

[216] See Treas. Reg. secs. 1.167(a)-10(b), -3, -14, and 1.197-2(f). See also Treas. Reg. sec. 1.167(a)-11(e)(1)(i).

[217] Sec. 168.

[218] See sec. 168(e) and (g).

[219] Exercising authority granted by Congress, the Secretary issued Rev. Proc. 87-56, 1987-2 C.B. 674, laying out the framework of recovery periods for enumerated classes of assets. The Secretary clarified and modified the list of asset classes in Rev. Proc. 88-22, 1988-1 C.B. 785. In November 1988, Congress revoked the Secretary's authority to modify the class lives of depreciable property. Rev. Proc. 87-56, as modified, remains in effect except to the extent that the Congress has, since 1988, statutorily modified the recovery period for certain depreciable assets, effectively superseding any administrative guidance with regard to such property.

[220] Sec. 168(c).

[221] Sec. 168(b)(3)(A) and (B).

[222] Sec. 168(e)(2)(A).

one-half of the units in which are used on a transient basis. If any portion of the building or structure is occupied by the taxpayer, the gross rental income from such property includes the rental value of the portion so occupied. Alternatively, the term "nonresidential real property" means section 1250 property that is not residential rental property or property with a class life of less than 27.5 years.[223]

Placed in service convention

Depreciation of an asset begins when the asset is deemed to be placed in service under the applicable convention.[224] Under MACRS, nonresidential real property and residential rental property are subject to the mid-month convention, which treats all property placed in service during any month (or disposed of during any month) as placed in service (or disposed of) on the mid-point of such month.[225]

Additions or improvements to property

The recovery period for any addition or improvement to real or personal property begins on the later of (1) the date on which the addition or improvement is placed in service, or (2) the date on which the property with respect to which such addition or improvement is made is placed in service.[226] Any MACRS deduction for an addition or improvement to any property is to be computed in the same manner as the deduction for the underlying property would be if such property were placed in service at the same time as such addition or improvement. Thus, for example, the cost of an improvement to a building that constitutes nonresidential real property is generally recovered over 39 years using the straight line method and mid-month convention. However, an exception to the 39-year recovery period applies to qualified improvement property, as described below.

Qualified improvement property

Qualified improvement property is any improvement made by the taxpayer to an interior portion of a building that is nonresidential real property if such improvement is placed in service by the taxpayer after the date such building was first placed in service by any taxpayer.[227] Qualified improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building.[228] Qualified improvement property is generally depreciable using the

[223] Sec. 168(e)(2)(B).

[224] Treas. Reg. sec. 1.167(a)-10(b).

[225] Sec. 168(d)(2) and (d)(4)(B).

[226] Sec. 168(i)(6).

[227] Sec. 168(e)(6)(A).

[228] Sec. 168(e)(6)(B).

straight line method,[229] half-year convention,[230] and a 15-year recovery period.[231] Improvements made to residential rental property do not meet the definition of qualified improvement property. Hence, the cost of an improvement to residential rental property is generally recovered over 27.5 years using the straight line method and mid-month convention.

Land and land improvements

Land is generally not depreciable.[232] However, certain improvements to land (*e.g.*, sidewalks, roads, fencing, shrubbery) are depreciable if they are subject to wear and tear, to decay or decline from natural causes, to exhaustion, and/or to obsolescence.[233] The cost of depreciable land improvements is generally recovered using the 150 percent declining balance method,[234] a recovery period of 15 years,[235] and the half-year convention.[236]

Alternative depreciation system

The alternative depreciation system ("ADS") is required to be used for tangible property used predominantly outside the United States, certain tax-exempt use property, tax-exempt bond financed property, certain imported property covered by an Executive order, and certain property

[229] Sec. 168(b)(3)(G).

[230] Sec. 168(d)(1). The half-year convention treats all property placed in service during any taxable year (or disposed of during any taxable year) as placed in service (or disposed of) on the mid-point of such taxable year. Sec. 168(d)(4)(A). However, if substantial property is placed in service during the last three months of a taxable year, a special rule requires use of the mid-quarter convention, which treats all property placed in service (or disposed of) during any quarter as placed in service (or disposed of) on the mid-point of such quarter. Sec. 168(d)(3) and (d)(4)(C). The mid-quarter convention does not apply to nonresidential real property or residential rental property; thus, such property is not taken into account in determining if the mid-quarter convention applies. Sec. 168(d)(3)(B); Treas. Reg. sec. 1.168(d)-1.

[231] Sec. 168(e)(3)(E)(vii). Note that as 15-year property, qualified improvement property is generally eligible for the additional first-year depreciation deduction under section 168(k) (this additional first-year depreciation is commonly referred to as "bonus depreciation"). Qualified improvement property is also eligible for section 179 expensing. See sec. 179(e)(1). Note that the amount of the bonus depreciation deduction is determined after basis adjustments for any section 179 expensing. See Treas. Reg. sec. 1.168(k)-1(a)(2)(iii). For a discussion of expensing under sections 168(k) and 179, see Joint Committee on Taxation, *Tax Incentives for Domestic Manufacturing* (JCX-15-21), March 12, 2021, pp. 7-14.

[232] Treas. Reg. sec. 1.167(a)-2. See also Treas. Reg. sec. 1.263(a)-1 through -3 (requirements to capitalize amounts paid to acquire, produce, or improve tangible property).

[233] *Ibid.*

[234] Under the 150 percent declining balance method, the depreciation rate is determined by dividing 150 percent by the appropriate recovery period, switching to the straight line method for the first taxable year where using the straight line method with respect to the adjusted basis as of the beginning of that year yields a larger depreciation allowance. Sec. 168(b)(1) and (b)(2).

[235] See asset class 00.3 of Rev. Proc. 87-56, 1987-2 C.B. 674. Note that as 15-year property, depreciable land improvements are generally eligible for the additional first-year depreciation deduction under section 168(k).

[236] See sec. 168(b)(2)(A) and asset class 00.3 of Rev. Proc. 87-56, 1987-2 C.B. 674.

held by either a real property trade or business[237] or a farming business[238] electing out of the business interest limitation under section 163(j).[239] In addition, an election to use ADS is available to taxpayers for any class of property for any taxable year.[240]

Under ADS, all property is depreciated using the straight line method and the applicable convention over recovery periods which generally are equal to the class life of the property, with certain exceptions.[241] For example, nonresidential real property has a 40-year ADS recovery period,[242] residential rental property generally has a 30-year ADS recovery period,[243] qualified improvement property has a 20-year ADS recovery period,[244] and land improvements generally have a 20-year ADS recovery period.[245]

Depreciation recapture

In general

Upon disposition of most property used in a business with respect to which depreciation or amortization deductions were taken, the treatment of the resulting gain or loss as ordinary or capital depends on whether there is a net gain or a net loss under section 1231.[246] If the netting

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[237] An electing real property trade or business is defined in section 163(j)(7)(B) by cross reference to section 469(c)(7)(C) (*i.e.*, any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business).

[238] An electing farming business is defined in section 163(j)(7)(C), which defines an electing farming business as (i) a farming business as defined in section 263A(e)(4), or (ii) any trade or business of a specified agricultural or horticultural cooperative as defined in section 199A(g)(4) (a clerical correction may be necessary to correct this reference).

[239] Sec. 168(g)(1).

[240] Sec. 168(g)(1)(E) and (g)(7). While property that must be depreciated using ADS (*e.g.*, residential rental property held by an electing real property trade or business) does not qualify for bonus depreciation under section 168(k), taxpayers may claim bonus depreciation on qualified property for which they elect to depreciate under ADS pursuant to section 168(g)(7). See sec. 168(k)(2)(D)(i).

[241] Sec. 168(g)(2) and (3).

[242] Sec. 168(g)(2)(C)(iv).

[243] Sec. 168(g)(2)(C)(iii). The 30-year ADS recovery period generally applies to residential rental property placed in service after December 31, 2017, while a 40-year ADS recovery period generally applies to residential rental property placed in service before January 1, 2018. However, any residential rental property held by an electing real property trade or business under section 163(j) that was placed in service before January 1, 2018, is depreciated using a 30-year ADS recovery period if such property was not subject to ADS (regardless of whether the use of ADS was required or elected) prior to January 1, 2018. See sec. 202 of the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Pub. L. No. 116-260 (Dec. 27, 2020). See also, Rev. Proc. 2021-28, 2021-27 I.R.B. 5.

[244] Sec. 168(g)(3)(B).

[245] Sec. 168(g)(2)(C)(i). See also, Asset Class 00.3 of Rev. Proc. 87-56, 1987-2 C.B. 674.

[246] Section 1231 applies to gains and losses on the sale, exchange, or involuntary conversion of certain assets used in the taxpayer's trade or business. These assets are not capital assets, as that term is generally defined

of gains and losses results in a net gain, then, subject to the depreciation recapture rules, long-term capital gain treatment generally results.[247] If the netting of gains and losses results in a loss, the loss is fully deductible against ordinary income.[248]

The depreciation recapture rules require taxpayers to recognize ordinary income in an amount equal to all or a portion of the gain realized as a result of the disposition of property. The purpose of the rules is to limit a taxpayer's ability to reduce ordinary income via depreciation deductions and then receive capital gain treatment for the portion of any gain on the disposition of the depreciated property that resulted from the taking of depreciation deductions. There are two regimes that dictate depreciation recapture, sections 1245 and 1250.[249] In addition, sections 1245 and 1250 generally override various nonrecognition provisions in the Code.[250]

Section 1245

Depreciable personal property, whether tangible or intangible, and certain depreciable real property (typically real property that performs specific functions in a business, but not buildings or structural components of buildings) disposed of at a gain are known as section 1245 property.[251] In addition to depreciation under section 167, the section 1245 recapture rules apply to other cost recovery provisions, including first-year expensing provisions.[252]

When a taxpayer disposes of section 1245 property, the taxpayer must (before application of section 1231) recapture the gain on disposition of the property as ordinary income to the extent of earlier depreciation or amortization deductions taken with respect to the asset.[253] Any

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in the Code (see sec. 1221(a)). The assets eligible for this treatment include depreciable property or real property held for more than one year and used in a trade or business (if not includible in inventory, held primarily for sale to customers in the ordinary course of business, or property described in section 1221(a)(3) or (5)). Sec. 1231(b)(1). Also included are certain special assets important in particular industries, such as interests in timber, coal, domestic iron ore, certain livestock, and certain unharvested crops. Sec. 1231(b)(2) through (4).

[247] Sec. 1231(a)(1). However, net section 1231 gain is converted into ordinary income to the extent net section 1231 losses in the previous five years were treated as ordinary losses. Sec. 1231(c). In addition, net gains may be denied capital gains treatment (and taxed as ordinary income) if the transaction is between certain related taxpayers. See sec. 1239.

[248] Sec. 1231(a)(2).

[249] Cost recovery deductions taken under the Accelerated Cost Recovery System ("ACRS") (for property placed in service after 1980 and before 1987 (before August 31, 1986, if the taxpayer so elected)) generally are subject to recapture; however, properties are not necessarily classified as section 1245 or 1250 property in the same manner as similar properties placed in service before or after ACRS.

[250] See Treas. Reg. secs. 1.1245-6(b) and 1.1250-1(c)(2).

[251] Sec. 1245(a)(3); Treas. Reg. sec. 1.1245-3.

[252] See sec. 1245(a)(2)(C) and (a)(3)(C). For example, any deduction allowed under section 179 is treated as if it were a deduction allowable for amortization.

[253] Sec. 1245(a)(1). Generally, all depreciation or amortization adjustments allowed or allowable must be taken into account. However, if a taxpayer can establish by adequate records or other sufficient evidence that the

remaining gain recognized upon the sale of section 1245 property is generally treated as section 1231 gain.

Section 1250

Depreciable real property, other than that included within the definition of section 1245 property, disposed of at a gain is known as section 1250 property.[254] For example, depreciable residential rental property is section 1250 property. Gain on the disposition of section 1250 property is treated as ordinary income, rather than capital gain, only to the extent of the excess depreciation or amortization taken over what would have been available under the straight line method.[255] However, if section 1250 property is held for one year or less, all depreciation is recaptured, regardless of whether it exceeds the depreciation that would have been available under the straight line method.[256] Special rules phase out the recapture for certain types of property held over a specified period of time.[257]

Since section 1250 recaptures only the excess of accelerated depreciation taken over straight line depreciation and MACRS requires straight line depreciation for nonresidential real property and residential rental property placed in service after 1986, such property placed in service after 1986 generally will not be subject to recapture under section 1250 (except to the extent that section 291(a) applies in the case of a corporation (discussed below)). However, bonus depreciation allowed or allowable with respect to qualified improvement property or land improvements constitutes additional depreciation for purposes of computing section 1250 recapture (*i.e.*, the bonus depreciation deduction is not a straight line method).[258]

For corporations, under section 291(a), the amount treated as ordinary income on the disposition of section 1250 property is increased by 20 percent of the additional amount that would be treated as ordinary income if the property were subject to recapture under the rules for section 1245 property. For example, if a corporation sells residential rental property that it held for more than one year, even though the corporation did not claim accelerated depreciation, it is required to recognize ordinary income equal to 20 percent of the lesser of the total amount of depreciation deducted or the gain on the sale. While no separate rate structure exists for

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amount allowed for depreciation or amortization for any period was less than the amount allowable for such period, the taxpayer may take into account only the amount allowed. Treas. Reg. sec. 1.1245-2(a)(7).

[254] Sec. 1250(c); Treas. Reg. sec. 1.1250-1(e).

[255] Sec. 1250(a).

[256] Sec. 1250(b)(1).

[257] Sec. 1250(a)(1)(B). The special phase-out rule applies to residential low-income rental property, certain types of subsidized housing, and property for which rapid depreciation of rehabilitation expenditures was claimed under section 167(k) as in effect on the date before the date of the enactment of the Revenue Reconciliation Act of 1990.

[258] See Treas. Reg. sec. 1.168(k)-2(g)(3). Similarly, in the case of qualified real property (*e.g.*, qualified improvement property) for which the unadjusted basis is reduced by a section 179 deduction, the amount of such reduction is treated as section 1245 property, and the remaining unadjusted basis is treated as section 1250 property. See Notice 2013-59, 2013-40 I.R.B. 297, for special rules for determining the portion of the gain that is attributable to section 1245 property upon the sale or other disposition of qualified real property.

corporate capital gains,[259] a corporation may not deduct the amount of capital losses in excess of capital gains for any taxable year. Disallowed capital losses may be carried back three years or carried forward five years.[260]

For individuals, estates, and trusts, any capital gain that would be treated as ordinary income if the property were subject to recapture under the rules for section 1245 property is generally taxed at a maximum rate of 25 percent.[261] This is referred to as "unrecaptured section 1250 gain."[262] The amount of unrecaptured section 1250 gain (before the reduction for the net loss) attributable to the disposition of property to which section 1231 applies may not exceed the net section 1231 gain for the year.[263] Any gain in excess of unrecaptured section 1250 gain is eligibl]e for the 15 percent capital gains rate.[264]

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[259] Income of a corporation is generally taxed at 21 percent (sec. 11).

[260] Sec. 1212(a).

[261] Sec. 1(h)(1)(E) and (h)(6)(A).

[262] See section 1(h)(6), which defines "unrecaptured 1250 gain" as any long-term capital gain from the sale or exchange of section 1250 property held more than one year to the extent of the gain that would have been treated as ordinary income if section 1250 applied to all depreciation, reduced by the net loss (if any) attributable to the items taken into account in computing 28-percent rate gain of an individual.

[263] Sec. 1(h)(6)(B).

[264] Sec. 1(h)(1)(C).

E. Passive Activity Loss Rules and Special Rental Real Estate Rules

In general

The passive loss rules limit deductions and credits from passive trade or business activities.[265] Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income, such as wages, portfolio income, or business income that is not derived from a passive activity. A similar rule applies to credits. Deductions and credits that are suspended under these rules are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses from a passive activity are allowed in full when a taxpayer disposes of his entire interest in the passive activity in a fully taxable transaction to an unrelated person.

The passive loss rules apply to individuals, estates and trusts, closely held C corporations, and personal service corporations. A special rule permits closely held C corporations to apply passive activity losses and credits against active business income (or tax liability allocable thereto) but not against portfolio income.

Passive activities are defined to include trade or business activities in which the taxpayer does not materially participate. Except as provided in regulations,[266] no interest as a limited partner is treated as an interest with respect to which the taxpayer materially participates.

A passive activity does not include a working interest in any oil or gas property that the taxpayer holds directly or through an entity that does not limit the liability of the taxpayer with respect to the interest. This rule applies without regard to whether the taxpayer materially participates in the activity.

Special rules for rental real estate activities

Rental activities (generally including rental real estate activities) are treated as passive activities, regardless of the level of the taxpayer's participation. However, a special rule treats a taxpayer's rental real estate activities in which he materially participates as not subject to limitation under the passive loss rules if the taxpayer meets eligibility requirements. To be eligible, (1) more than half of the personal services the taxpayer performs in trades or businesses during the taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and (2) the taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.

Another special rule permits the deduction of up to $25,000 of losses from rental real estate activities in which the taxpayer actively participates. The $25,000 amount is allowed for taxpayers with adjusted gross incomes of $100,000 or less and is phased out for taxpayers with adjusted gross incomes between $100,000 and $150,000. In the case of any portion of the passive activity credit for any taxable year attributable to the rehabilitation credit, the phase-out

[265] Sec. 469.

[266] Treas. Temp. Reg. sec. 1.469-5T.

begins at $200,000. The phase-out does not apply to any portion of the passive activity credit for any taxable year which is attributable to the low-income housing credit.[267]

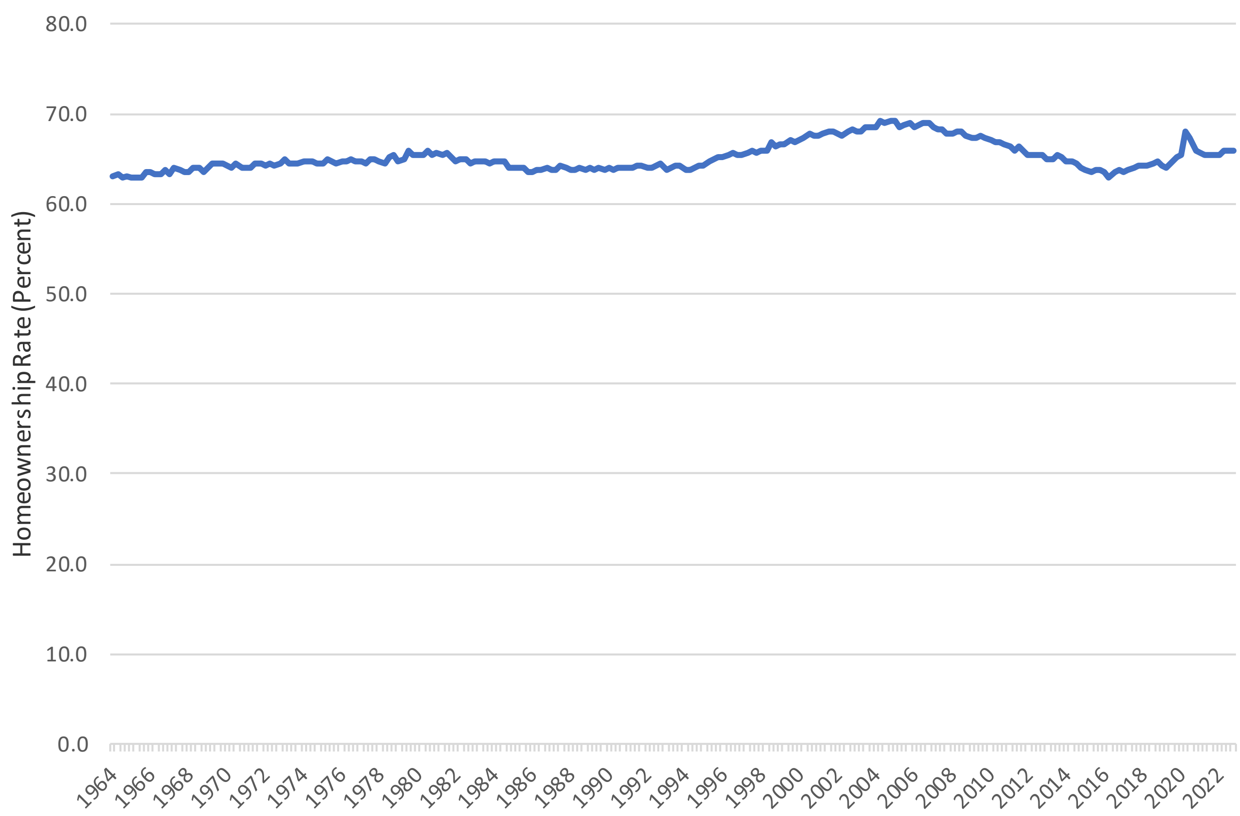
[267] Sec. 469(i)(3)(B) and (C).

III. DATA AND ANALYSIS RELATED TO TAX INCENTIVES FOR HOMEOWNERSHIP

In general

Figure 1 shows homeownership rates in the United States from the first quarter of 1964 through the fourth quarter of 2022. The homeownership rate is the number of owner-occupied housing units divided by the total number of occupied housing units. The figure shows that over the last half century, the homeownership rate has fluctuated between a low of 62.9 percent in several quarters of 1964 and 1965 to a high of 69.2 percent in two quarters of 2004.[268]

Figure 1.–U.S. Homeownership Rate, 1964-2022, Quarterly



Source: U.S. Census Bureau, Current Population Survey/Housing Vacancy Survey, January 31, 2023.

Certain tax provisions under present law may encourage homeownership. For example, consider the treatment of the unobserved rental value of a homeowner's home, or imputed rent. An owner of a residential rental property, or landlord, is generally allowed to deduct

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[268] The Census Bureau notes that data before 1994 and data after 1994 may not be directly comparable, due to the move to a fully computerized survey in 1994. See U.S. Census, Housing Vacancies and Homeownership, Fourth Quarter 2022, Source and Accuracy, available at https://www.census.gov/housing/hvs/files/qtr422/source_22q4.pdf, last visited February 21, 2023 (providing a description of changes to the sampling and methodology over time, including a description of changes in response to the coronavirus pandemic).

depreciation, interest on the indebtedness incurred in connection with the property, and other costs. Rent paid to live in the property is includable in income for the landlord and is not deductible as an expense for the tenant. While a homeowner can be thought of as both a landlord and a tenant, homeowners do not include imputed rent in income.[269] Consequently, the exclusion of imputed rent is a preference for homeowners. An efficient income tax system would tax all income in the same way, implying a tax on imputed rental income, net of interest, taxes, depreciation, and insurance. An alternative approach would be to exclude imputed rental income but deny deductions for mortgage interest, property taxes, depreciation, and insurance.[270] Because under present law homeowners are generally allowed to deduct mortgage interest and property taxes to determine their taxable income and are not taxed on imputed rental income, but renters are not allowed to deduct rental payments, the current tax system incentivizes taxpayers to buy rather than rent a home, and to finance the acquisition of a home with debt. An exclusion of up to $500,000 in gross income from capital gain from the sale of a primary residence also reduces the overall cost of homeownership. Additionally, penalty-free withdrawals from tax-advantaged retirement plans increase the liquid funds available for taxpayers to make down payments on homes. These and other tax subsidies that may encourage homeownership (besides the exclusion from imputed rent already described here) are discussed in more detail below.

Economics provides a theoretical framework of "externalities" in the consumption or production of certain goods that may serve as a rationale for government intervention in certain markets, like the market for owner-occupied housing. Externalities exist when, in the consumption or production of a good, there is a difference between the cost (or benefit) to an individual and the cost (or benefit) to society as a whole. These externalities lead to mismatches between individual and social costs (or benefits) that result in the purely market-based outcome providing either too little or too much of certain economic activity, relative to what is socially optimal. Thus, in certain settings, tax preferences that encourage increased or decreased consumption or production, as appropriate, can help to achieve an increase in economic efficiency by moving consumption or production toward the socially optimal level.

Proponents of tax incentives for homeownership argue that there are positive externalities to homeownership. Therefore, tax incentives to encourage homeownership may be justified since the social benefits exceed the private benefits of homeownership, and thus in the absence of such incentives the resulting market would have too little homeownership.

At the same time, the presence of positive externalities from homeownership alone may not be sufficient justification for tax incentives for homeownership. Any gains to efficiency due to intervention in the housing market may be offset by losses in efficiency in other markets, for example by distorting taxpayer location decisions, or from higher distortionary taxes unrelated to homeownership to finance the tax incentive for homeownership.

Recognizing that tax incentives for homeownership may be justified in certain situations is just one consideration when determining the appropriate policy. Policymakers may also want

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[269] The rental value of owner-occupied housing is an important component of the Bureau of Economic Analysis's National Income and Product Accounts which include estimates of gross domestic product ("GDP"). See BEA, *NIPA Handbook: Concepts and Methods of the U.S. National Income and Product Accounts*, December 2022.

[270] OECD, *Tax Policy Reform and Economic Growth*, OECD Publishing, 2010, p. 93, available at https://www.oecd.org/ctp/tax-policy/tax-policy-reform-and-economic-growth-9789264091085-en.htm, last visited March 1, 2023.

to consider the magnitude and form of a subsidy. For example, it is possible to create inefficient outcomes by over-subsidizing a good that produces positive externalities. In addition to providing tax preferences for homeowners, the Federal government assists in the financing of home purchases through other programs. The Federal Housing Administration ("FHA"), the Department of Veterans Affairs ("VA"), and the Department of Agriculture ("USDA") provide mortgage guarantees[271] and directly provide mortgage loans in certain cases.[272] Government-sponsored enterprises, the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac"), and the Government National Mortgage Association ("Ginnie Mae") support the secondary market for mortgages by, for example, guaranteeing mortgage loans and issuing or guaranteeing mortgage-backed securities.[273]

Therefore, the effectiveness of current tax preferences for owner-occupied housing may be evaluated by assessing whether (1) homeownership generates net positive externalities, (2) tax preferences increase the number of homeowners, and (3) such tax preferences cause unintended distortions.

Empirical evidence of homeownership externalities

Economists have found suggestive evidence for at least three channels through which homeownership generates externalities, both positive and negative.[274] First, there is evidence that homeowners maintain their homes better than renters (or landlords).[275] This may yield aesthetic benefits to others and may foster other desirable neighborhood characteristics, such as lower levels of crime. Second, the fact that the value of a home is often closely linked to the strength of the community may encourage homeowners, more than renters, to support long-term

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[271] For details on Federal mortgage guarantees on loans, see https://www.hud.gov/program_offices/housing/fhahistory (FHA), https://www.benefits.va.gov/homeloans/ (VA), and https://www.rd.usda.gov/sites/default/files/fact-sheet/508_RD_FS_RHS_SFHGLP.pdf (USDA); last visited February 21, 2023.

[272] For details on the USDA's Section 502 Direct Loan Program, see https://www.rd.usda.gov/sites/default/files/fact-sheet/508_RD_FS_RHS_SFH502Direct.pdf, last visited February 21, 2023.

[273] For details, see https://www.fanniemae.com/about-us/what-we-do (Fannie Mae), https://www.freddiemac.com/about (Freddie Mac), https://www.ginniemae.gov/about_us/who_we_are/Pages/funding_government_lending.aspx (Ginnie Mae); last visited February 21, 2023.

[274] See Edward L. Glaeser and Jesse M. Shapiro, "The Benefits of the Home Mortgage Interest Deduction," in James M. Poterba (ed.), *Tax Policy and the Economy 17*, The MIT Press, 2003, pp. 37-82 for a review of the literature on externalities. See also N. Edward Coulson and Herman Li, "Measuring the External Benefits of Homeownership," *Journal of Urban Economics*, vol. 77, September 2013, pp. 57-67.

[275] George Galster, "Empirical Evidence on Cross-Tenure Differences in House Maintenance and Conditions," *Land Economics*, vol. 59, February 1983, pp. 107-113. John Harding, Thomas J. Miceli, and C. F. Sirmans, "Do Owners Take Better Care of Their Housing Than Renters?," *Real Estate Economics*, vol. 28, December 2000, pp. 663-681. Denise DiPasquale and Edward L. Glaeser, "Incentives and Social Capital: Are Homeowners Better Citizens?," *Journal of Urban Economics*, vol. 45, March 1999, pp. 354-384.

community investments.[276] The incentive to raise house prices, however, might also lead homeowners to restrict the supply of new homes artificially through land use regulation.[277] Third, homeownership has been found to reduce residential mobility.[278] Reduced mobility may provide owners with a longer time horizon over which to evaluate community investments (whether through involvement in local civic organizations or investments in local government goods and services). Neighborhood stability may also be associated with lower crime.[279] Reduced mobility, however, may have negative consequences for the labor market if it discourages people from moving for jobs for which they may be better suited or encourages them to accept jobs for which they may be relatively poorly matched.[280]

Tax subsidies for homeownership

Mortgage interest deduction

The deduction for home mortgage interest reduces the after-tax cost of financing and maintaining a home for taxpayers that itemize deductions. As a result of changes to the Code made by Public Law 115-97 (the "2017 Tax Act"),[281] namely the increase in the standard deduction and the changes to itemized deductions (such as the temporary $10,000 limitation on State and local tax deductions and the suspension of miscellaneous itemized deductions), the optimal decision for more taxpayers is to claim the standard deduction, rather than to claim itemized deductions.[282] Therefore, fewer taxpayers claim, or are incentivized by, the mortgage interest deduction.[283] The Joint Committee staff estimates that for the 2023 tax year

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[276] Renters may actually be worse off if property values and rents rise disproportionately to the direct benefits renters receive from these investments.

[277] Edward L. Glaeser and Jesse M. Shapiro, "The Benefits of the Home Mortgage Interest Deduction," in James M. Poterba (ed.), *Tax Policy and the Economy 17*, The MIT Press, 2003, p. 69.

[278] Fernando Ferreira, Joseph Gyourko, and Joseph Tracy, "Housing Busts and Household Mobility," *Journal of Urban Economics*, vol. 68, July 2010, pp. 34-45. Andrew Henley, "Residential Mobility, Housing Equity, and the Labour Market," *Economic Journal*, vol. 108, March 1998, pp. 414-427.

[279] Charis E. Kubrin, "Structural Covariates of Homicide Rates: Does Type of Homicide Matter?," *Journal of Research in Crime and Delinquency*, vol. 40(2), 2003, pp. 139-170. Lauren J. Krivo and Ruth D. Peterson, "The Structural Context of Homicide: Accounting for Racial Differences in Process," *American Sociological Review*, vol. 65(4), 2000, pp. 547-559. For contrary findings, see Corina Graif and Robert J. Sampson, "Spatial Heterogeneity in the Effects of Immigration and Diversity on Neighborhood Homicide Rates," *Homicide Studies*, vol. 13(3), 2009, pp. 242-260 and Robert J. Sampson, Stephen W. Raudenbush, and Felton Earls, "Neighborhoods and Violent Crime: A Multilevel Study of Collective Efficacy," *Science*, vol. 277, August 1997, pp. 918-924.

[280] Richard K. Green and Patric H. Hendershott, "Home-ownership and Unemployment in the US," *Urban Studies*, vol. 38(9), 2001, pp. 1509-1520.

[281] December 22, 2017.

[282] For 2023 the amount of the standard deduction is $13,850 for a single individual and for a married individual filing separately, $20,800 for a head of household, and $27,700 for married individuals filing jointly and for a surviving spouse.

[283] As described above, the 2017 Tax Act also reduced the maximum amount of acquisition indebtedness on which interest is deductible from $1 million to $750,000.

approximately 10 percent of taxpayers will itemize deductions (compared to 32 percent for 2017).

Itemizers, and specifically taxpayers who claim the mortgage interest itemized deduction, tend to be higher in the income distribution. This is especially the case after the enactment of the 2017 Tax Act. Because marginal tax rates increase with income, the average tax savings from the mortgage interest deduction increases as annual household income increases. Table 1, below, shows this pattern for the mortgage interest deduction.[284]

[284] For historic estimates and distributions of the mortgage interest deduction and tax expenditure see David Splinter, "The Mortgage Interest Deduction: Causes of Fluctuations in a Procyclical Tax Expenditure," *Public Finance Review*, vol. 47(5), 2019, pp. 807-827.

Table 1.–Distribution of Mortgage Interest Deduction, 2023 (Projected)

Income Category [1]	All Taxpayers		Taxpayers Claiming Mortgage Interest Deduction	
	Returns [2] (Thousands)	Income ($ Millions)	Returns (Thousands)	Amount ($ Millions)
Less than $15,000..	21,357	144,491	52	694
$15,000 to $30,000......................................	24,358	554,947	105	1,322
$30,000 to $40,000......................................	16,991	590,612	122	2,343
$40,000 to $50,000......................................	14,068	632,088	156	1,628
$50,000 to $60,000......................................	13,054	716,935	236	2,534
$60,000 to $80,000......................................	21,438	1,487,686	700	6,952
$80,000 to $100,000....................................	14,928	1,335,115	896	9,189
$100,000 to $150,000..................................	24,241	2,968,070	2,449	27,566
$150,000 to $200,000..................................	13,166	2,271,730	1,822	23,755
$200,000 to $500,000..................................	16,285	4,599,338	4,097	69,914
$500,000 to $1,000,000...............................	2,180	1,456,377	954	21,057
$1,000,000 and over....................................	968	3,169,571	491	11,988
Total, All Taxpayers....................................	183,033	19,926,960	12,080	178,944

[1] The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: (1) tax-exempt interest, (2) employer contributions for heal h plans and life insurance, (3) employer share of FICA tax, (4) workers' compensation, (5) nontaxable Social Security benefits, (6) insurance value of Medicare benefits, (7) alternative minimum tax preference items, (8) individual share of business taxes, and (9) excluded income of U.S. citizens living abroad. Categories are measured at 2023 levels.

[2] Includes nonfilers, excludes dependent filers and returns with negative income.

Source: Joint Committee on Taxation staff estimates.

Studies that compare the mortgage interest deduction and homeownership rates over time within the United States and across countries generally provide no strong evidence of a relationship between the two.[285] Recent empirical work finds that the mortgage interest deduction may cause borrowers to purchase larger and more expensive homes (adjusting on the "intensive margin") and increase the level of debt financing, but it has little to no effect on the decision of whether to purchase a home (adjusting on the "extensive margin").[286] Other research that does find some evidence of a meaningful effect of the mortgage interest deduction on homeownership rates finds a positive relationship between the two only in markets where positive externalities from homeownership are less likely to exist.[287]

[285] Edward L. Glaeser and Jesse M. Shapiro, "The Benefits of the Home Mortgage Interest Deduction," *Tax Policy and the Economy,* vol 17, 2003, pp. 37-82. Roberta F. Mann, "The (Not So) Little House on the Prairie: The Hidden Costs of the Home Mortgage Interest Deduction," *Arizona State Law Journal,* vol. 32, 2000, pp. 1347-1396.

[286] Andrew Hanson, "Size of Home, Homeownership, and the Mortgage Interest Deduction," *Journal of Housing Economics*, vol. 21, 2012, pp. 195–210. Jonathan Gruber, Amalie Jensen, and Henrik Kleven, "Do People Respond to the Mortgage Interest Deduction? Quasi-Experimental Evidence from Denmark," *American Economic Journal: Economic Policy,* vol. 13(2), pp. 273-303.

[287] See Christian A. L. Hilber and Tracy M. Turner, "The Mortgage Interest Deduction and its Impact on Homeownership Decisions," *The Review of Economics and Statistics*, MIT Press, vol. 96(4), 2014, pp. 618-637. The authors find a positive effect of the mortgage interest deduction among higher-income groups in elastically supplied housing markets, that is, places with lax land use rules and room to build new homes, but argue that positive externalities related to homeownership are likely confined to places with inelastic housing supply, typically

Deduction for real property taxes

Similar to the deduction for home mortgage interest, the deduction for real property taxes reduces the after-tax cost of financing and maintaining a home for taxpayers that itemize deductions. Because the deduction for real property taxes is an itemized deduction, the benefit of the deduction tends to accrue to taxpayers in the higher end of the income distribution, similar to the deduction for home mortgage interest. Table 2, below, shows this pattern for the deduction for State and local taxes (including property taxes). The temporary $10,000 aggregate limitation on the deduction for State and local real property, personal property, and income (or sales) taxes further restricts the set of taxpayers that may be incentivized and benefit from the deduction.[288]

Table 2.–Distribution of State and Local Tax Deduction, 2023 (Projected)

Income Category [1]	All Taxpayers		Taxpayers Claiming State and Local Tax Deduction	
	Returns [2] (Thousands)	Income ($ Millions)	Returns (Thousands)	Amount ($ Millions)
Less than $15,000..	21,357	144,491	122	460
$15,000 to $30,000.....................................	24,358	554,947	194	817
$30,000 to $40,000.....................................	16,991	590,612	266	1,165
$40,000 to $50,000.....................................	14,068	632,088	315	1,733
$50,000 to $60,000.....................................	13,054	716,935	414	2,307
$60,000 to $80,000.....................................	21,438	1,487,686	1,124	6,537
$80,000 to $100,000...................................	14,928	1,335,115	1,245	8,436
$100,000 to $150,000.................................	24,241	2,968,070	3,163	24,950
$150,000 to $200,000.................................	13,166	2,271,730	2,281	20,317
$200,000 to $500,000.................................	16,285	4,599,338	4,845	46,372
$500,000 to $1,000,000..............................	2,180	1,456,377	1,172	11,753
$1,000,000 and over...................................	968	3,169,571	696	7,093
Total, All Taxpayers...................................	183,033	19,926,960	15,837	131,940

[1] The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: (1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) employer share of FICA tax, (4) workers' compensation, (5) nontaxable Social Security benefits, (6) insurance value of Medicare benefits, (7) alternative minimum tax preference items, (8) individual share of business taxes, and (9) excluded income of U.S. citizens living abroad. Categories are measured at 2023 levels.
[2] Includes nonfilers, excludes dependent filers and returns with negative income.
Source: Joint Committee on Taxation staff estimates.

densely populated areas with tight regulation, where investment in local public goods is capitalized into local house prices.

[288] For example, a taxpayer with $10,000 in State income or sales taxes would receive the same deduction as a taxpayer with $10,000 in State income or sales taxes and $5,000 in real property taxes.

Proponents and critics of the State and local tax deduction generally focus on issues other than the effects of the deduction on homeownership, such as whether the deduction allows for a more appropriate measure taxpayer's ability to pay taxes or whether the taxes should be regarded as payments for State and local services.[289] Generally, research on the effects of the State and local tax deduction finds that States and localities alter the composition of State and local revenue collection toward Federally deductible taxes.[290] This suggests that property taxes may be higher than in the absence of the deduction, muting the incentive benefit of the deduction.

Capital gains exclusion for primary residence

Generally, taxpayers do not include an item of gain or loss in gross income until they realize a gain or loss. Under present law, with respect to property, realization generally occurs when the taxpayer sells, exchanges, or otherwise disposes of the asset on which the gain or loss has accrued. However, an exclusion for gains up to $500,000 from the sale of certain principal residences is allowed, which reduces the cost of homeownership for taxpayers with homes that increase in price.

Table 3 shows the Joint Committee staff's estimates of the exclusion of capital gains on sales of principal residences from 2014 to 2022.[291] Over this period, nominal housing prices increased by approximately 83 percent.[292]

Table 3.–Tax Expenditure Estimates of the Tax Savings from the Exclusion of Capital Gains on Sales of Principal Residences, 2014-2022

Fiscal Year	Exclusion of Capital Gains on Sale of Principal Residences ($ Billions)
2014	24.1
2015	24.1
2016	29.2
2017	32.9
2018	34.6

289 See Joint Committee on Taxation, *Background on the Itemized Deduction for State and Local Taxes* (JCX-35-19), June 24, 2019.

290 Bradley T. Heim and Yulianti Abbas, "Does Federal Deductibility Affect State and Local Revenue Sources?," *National Tax Journal*, March 2015, pp. 33-58. Mary N. Gade and Lee C. Adkins, "Tax Exporting and State Revenue Structures," *National Tax Journal*, March 1990, pp. 39-52. Martin S. Feldstein and Gilbert E. Metcalf, "The Effect of Federal Tax Deductibility on State and Local Taxes and Spending," *Journal of Political Economy*, August 1987, pp. 710-736.

291 These values are not adjusted for inflation.

292 The change in housing price is calculated using the quarterly all-transactions house price index produced by the Federal Housing Finance Agency comparing the third quarter of 2014 to the third quarter of 2022. This index measures the movement of single-family homes taking into account purchase and appraisal data.

Fiscal Year	Exclusion of Capital Gains on Sale of Principal Residences ($ Billions)
2019	34.7
2020	34.5
2021	46.3
2022	45.2

Source: Joint Committee on Taxation staff estimates.

Apart from incentivizing homeownership, another rationale for a capital gains exclusion for primary residences is to promote labor mobility. Since unrealized capital gains, including on homes, is deferred until realization, selling as a realization event may incur a substantial tax cost, reducing the incentive to move which is sometimes described as a "lock-in effect."

Empirical research on the effect of the capital gains exclusion for primary residences has found that reductions in capital gains taxes increased home sale rates[293] and the mobility of households.[294] This evidence supports the theory of a lock-in effect created by capital gains taxation of sales of primary residences. Some have proposed eliminating or indexing the limitation on the exclusion to alleviate mobility distortions.[295]

However, assets held until death may avoid tax through step-up basis, since an heir's basis is "stepped up" to the fair market value of the asset on the date of the decedent's death. For those taxpayers with gains exceeding any exclusion thresholds, the interaction with step-up basis at death may create a further lock-in effect as property held until death may be passed to heirs without incurring any Federal income tax. Another proposal would equalize treatment between current sales and transfers at death by eliminating step-up basis at death.

Exclusion from income of certain housing allowances and related deductions

The exclusion from income for the rental value of parsonages and the military basic allowance for housing may also incentivize home ownership for the members of the clergy and

[293] Hui Shan, "The Effect of Capital Gains Taxation on Home Sales: Evidence from the Taxpayer Relief Act of 1997," *Journal of Public Economics*, 2011, pp. 177-188. The author finds that changes to the capital gains treatment of homes enacted by Public Law 105-34, the "Taxpayer Relief Act of 1997," increased the semiannual sales rate of houses with gains up to $500,000 but finds no evidence of change for houses with gains above $500,000. The author uses subsequent changes in the capital gains tax rates to estimate a tax elasticity of home sales and finds increases in capital gains rates reduce semiannual home sales rates.

[294] Christopher R. Cunningham and Gary V. Englehardt, "Housing Capital-gains Taxation and Homeowner Mobility: Evidence from the Taxpayer Relief Act of 1997." *Journal of Urban Economics*, vol 63, no. 3, 2008, pp. 803-815. The authors find that the changes to the capital gains treatment of homes enacted by the Taxpayer Relief Act of 1997 increased residential mobility for homeowners just under age 55, who under prior law were not able to claim an exclusion for capital gains from a home.

[295] Gerald Auten and Jane G. Gravelle, "The Exclusion of Capital Gains on the Sale of Principal Residences: Policy Options," *Proceedings. Annual Conference of the National Tax Association*, vol. 102, 2009, pp. 103-112.

the military. These housing allowances are part of compensation. In general, compensation is deductible by the payor and includable in income of the payee. This exclusion allows compensation in the form of housing allowances to be excluded from income of certain taxpayers, creating an incentive to provide compensation in the form of housing allowances rather than other forms of compensation that are includable in income, such as wages. This exclusion is available whether the individual owns or rents a home. Moreover, in the case of a homeowner, no otherwise allowable deduction for mortgage interest or real property taxes is denied, notwithstanding the general rule that deductions related to tax-exempt income are not permitted. Thus, the taxpayer is permitted these deductions even though the income used to acquire the home and the imputed rental income from the owner-occupied housing are both excluded from income. These benefits make it relatively more attractive for the taxpayer to own rather than rent a home.

Taxation of income from the discharge of indebtedness

Taxation of income from the discharge of indebtedness may affect the incentives of households to borrow. In principle, taxation of this income reduces the net benefit of filing for bankruptcy and reduces incentives to borrow. It follows then that the exclusion of qualified principal residence indebtedness from Federal income taxation reduces the cost of borrowing and therefore increases the incentives to borrow to purchase a home.

Researchers are divided on the main causes of bankruptcy filings. Some studies claim that bankruptcy filings are primarily the result of adverse events (such as sickness, accidents, unemployment, divorce). Others claim that consumption patterns play a larger role. Some research finds that both may be strong contributors to bankruptcy.[296] If consumption patterns play an important role in households' decisions to file for bankruptcy, these filings may be strategic. That is, households may weigh costs and benefits in their decision to file. Furthermore, the availability of the option to file for bankruptcy can change households' consumption patterns if households are more likely to consume knowing they bear less than the full cost of consumption in the event of bankruptcy. Some research shows households do indeed behave strategically, filing for bankruptcy when the benefits of filing (for example, discharge of indebtedness) exceed the costs of filing (for example, forfeiture of assets).[297] Taxation of indebtedness income reduces incentives to borrow by reducing the net benefit of filing for bankruptcy. If adverse events are primarily responsible for bankruptcy filings, these incentives may have a smaller effect on actual borrowing. On the other hand, if consumption patterns are primarily responsible for bankruptcy filings, these incentives may have a larger effect on actual borrowing.

Special rules for distributions from IRAs and plan loans

The exception from the 10-percent early withdrawal tax for qualified first-time homebuyer distributions from certain traditional and Roth IRAs may decrease the overall cost of

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[296] Ian Domowitz and Robert L. Sartain, "Determinants of the Consumer Bankruptcy Decision," *The Journal of Finance* vol 54(1), 1999, pp. 403-420, find that both medical and credit card debt are strong contributors to bankruptcy.

[297] Scott Fay, Eric Hurst, and Michelle White, "The Household Bankruptcy Decision*," American Economics Review*, 92, 2002, pp. 706-718.

financing home purchases and therefore increase incentives for individuals to purchase a home. Similarly, certain special rules for loan proceeds used to purchase a principal residence allow individuals to access retirement funds for this purpose, thereby providing additional incentives to purchase a home.

Prior law first-time homebuyer incentives

A temporary first-time homebuyer credit was enacted on July 30, 2008 by Public Law 110-289 (the "Housing and Economic Recovery Act of 2008"), as a response to the economic downturn of 2007-2009 to support the U.S. housing market. As described above, the credit was modified several times subsequent to enactment. The later versions of this policy provided a refundable credit of up to $8,000 to first-time homebuyers, with an income limit or phaseout.

The policy directly targets taxpayers that do not own homes, as the benefit generally cannot be claimed by taxpayers that currently own homes. Empirical work finds that the credit, enacted at a time of housing market weakness, was effective in relatively increasing the number of homeowners.[298] The income limits and phaseout of the policy limit the benefit to accruing to taxpayers relatively lower in the distribution compared to some existing tax benefits for homeownership that are not limited by income, such as the mortgage interest deduction. However, the benefit still accrues to new homeowners, and homeowners as a group are wealthier than renters.[299]

[298] Hembre, Erik. "An Examination of the First-time Homebuyer Tax Credit." *Regional Science and Urban Economics* 73 (2018): 196-216. The author estimates that, per induced homeowner, the cost of the credit to the government is substantially lower than the cost of the mortgage interest deduction. However, the author also estimates that the cost of the credit is greater than the benefits from the externality of homeownership and greater than the cost of demolishing vacant homes.

Berger, David, Nicholas Turner, and Eric Zwick. "Stimulating Housing Markets." *The Journal of Finance* 75, no. 1 (2020): 277-321. The authors find that the credit increased home sales and house prices during the credit period with no sharp reversal in the two years following.

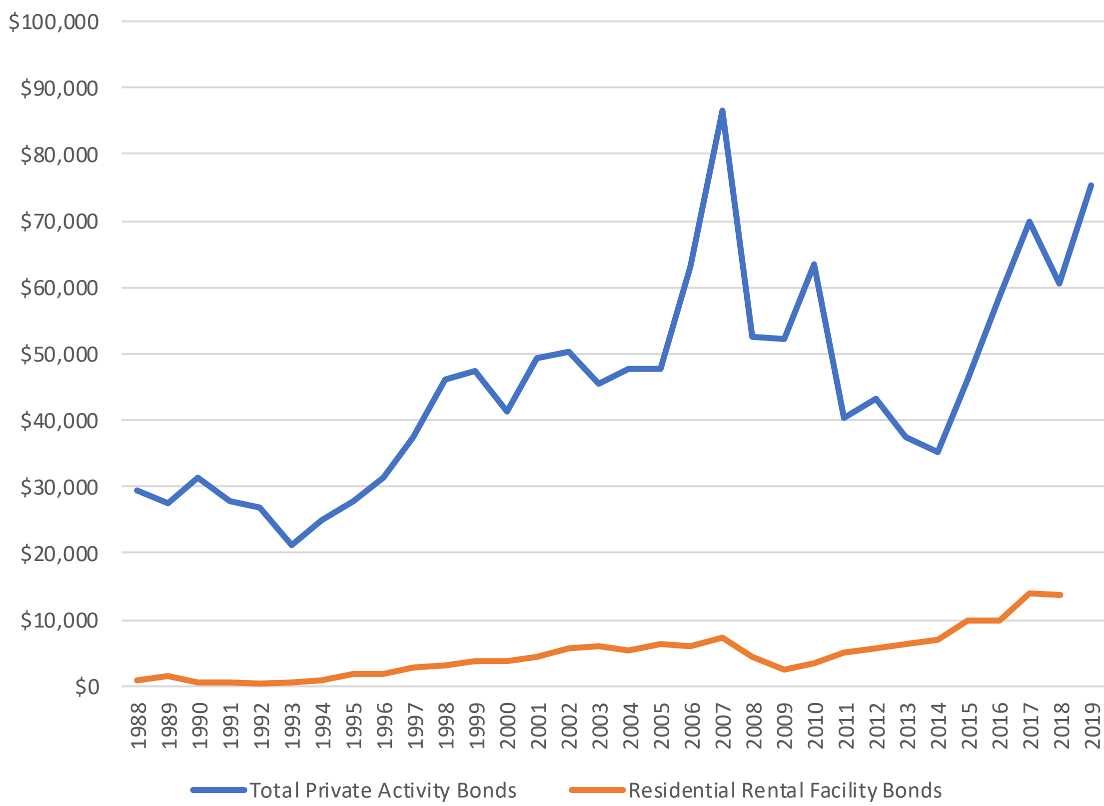
[299] Federal Reserve Bulletin, Board of Governors of the Federal Reserve System, "Changes in U.S. Family Finances from 2016 to 2019: Evidence from the Survey of Consumer Finances," vol. 106, no. 5, September 2020.

IV. DATA AND ANALYSIS RELATED TO TAX INCENTIVES FOR RENTAL HOUSING

Qualified private activity bonds

Gross income for Federal income tax purposes generally does not include interest paid on State or local qualified private activity bonds, including qualified private activity bonds issued to finance residential rental property. Figure 2 shows the volume of new money issuances of long-term private activity bonds in total and the volume of residential rental bonds since 1988 as reported to the IRS on Form 8038, Information Return for Tax-Exempt Private Activity Bond Issues. For 2019, $14.2 billion of qualified residential rental bonds for residential rental property were issued. Qualified residential rental facility bonds ranged from 1.5 percent to 22.6 percent of all new money issuances of qualified private activity bonds in each year from 1988 through 2019; the average for a single year in that period was 10 percent. By contrast, for 2019, $8.8 billion of qualified mortgage bonds were issued to finance owner-occupied housing, representing 11.6 percent of all new money issuances of qualified private activity bonds in that year.[300]

Figure 2.−Long-term Tax-Exempt Private Activity Bonds,
New Money Issuances, 1988-2019
(Millions of Dollars)



Source: IRS Statistics of Income, various years.

[300] IRS SOI Tax-Exempt Bond Statistics, 2019, available at https://www.irs.gov/statistics/soi-tax-stats-tax-exempt-bond-statistics.

The qualified residential rental bond program allows States to issue tax-exempt bonds to finance residential rental property. Because the interest on these bonds is excluded from gross income for Federal income tax purposes, and in some cases for State income tax purposes, investors are generally willing to accept a lower interest rate on these bonds than they might otherwise accept on a taxable investment, all else being equal. This, in turn, lowers the borrowing cost for the beneficiaries of such financing. Some of the benefits, however, may accrue to bond investors in higher marginal tax brackets in the form of higher after-tax returns rather than to borrowers in the form of reduced interest costs or renters in the form of lower rents.[301]

[301] For a discussion of economic issues relating to tax-exempt bond financing and a table showing historical implied marginal tax rates for the marginal investor, see Joint Committee on Taxation, *Present Law and Background Information Related to Federal Taxation and State and Local Government Finance* (JCX-7-13), March 15, 2013, pp. 50-56. See Joint Committee on Taxation, *The Federal Revenue Effects of Tax-Exempt and Direct-Pay Tax Credit Bond Provisions* (JCX-60-12), July 16, 2012, for a description of the economic modeling that the Joint Committee staff undertakes to assess the Federal revenue effects of tax-exempt bond provisions.

Furthermore, if the market-clearing purchaser of municipal bonds is likely to be in a higher income tax bracket than other bondholders, the loss of Federal tax receipts may be greater than the reduction in the interest cost of tax-exempt issuers. For example, consider a taxpayer with a 24-percent marginal tax rate who purchases a $1,000 taxable bond that pays 6 percent interest. This investor receives $60 in interest income and pays $14.40 in income tax, for an after-tax return of $45.60 and an after-tax yield of 4.56 percent. That return is the same as the return the taxpayer receives on a hypothetical $1,000 tax-exempt bond that pays 4.56 percent interest. In this scenario, the investor with the 24-percent marginal tax rate is indifferent between the taxable bond that pays 6 percent interest and the tax-exempt bond that pays 4.56 percent interest.

Now suppose a taxpayer with a 35-percent marginal tax rate purchases a $1,000 taxable bond that pays 6 percent interest. This investor receives $60 in interest income and pays $21 in income tax for an after-tax return of $39 and an after-tax yield of 3.9 percent. This investor prefers the hypothetical tax-exempt bond that pays 4.56 percent interest. Thus, unlike the investor in the 24-percent tax bracket who is indifferent to investment in either taxable or tax-exempt bonds, the bond investor in the 35-percent marginal tax bracket receives a benefit by purchasing the tax-exempt bond. In contrast, a bond investor with a 12-percent marginal tax rate receives no benefit from purchasing the tax-exempt bond, and in fact would have a lower after-tax return on the tax-exempt bond than on the purchase of a taxable bond paying six percent interest.

In the example above, the taxpayer with the 35-percent marginal tax rate is indifferent between the taxable bond and a hypothetical tax-exempt bond that pays 3.9 percent interest. In this scenario, a purchase of tax-exempt bonds that pays 4.5 percent interest results in a tax savings to the purchaser that is $6 greater than the tax savings with a tax-exempt bond paying 3.9 percent interest. That is, there is a reduction in Federal tax receipts of $6 more than the reduction in the interest cost of the tax-exempt issuer.

Low-income housing tax credit

The amount of low-income housing tax credit ("LIHTC") that may be claimed each year is based on the applicable percentage. Generally, the applicable percentage is determined such that the present value of the credits over a 10-year period is equal to 70 percent or 30 percent of a building's qualified basis. Such credits are sometimes referred to as "nine-percent credits" and "four-percent credits," respectively, based on the applicable percentages that were in effect in the first year of the LIHTC program. For buildings placed in service during 1987, the applicable percentages were set in statute at nine percent and four percent to yield credits with present values of approximately 70 percent and 30 percent, respectively. For buildings placed in service after 1987, the applicable percentages are calculated by Treasury based on prevailing interest rates while holding percent present values constant.[302] However, recent changes in law allow for the present value of credits to fluctuate, while the applicable percentages are subject to a floor. For buildings eligible for nine-percent credits and placed in service after July 30, 2008, there is a

[302] Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 252, October 22, 1986. The applicable percentage is adjusted monthly by the IRS on a discounted after-tax basis (assuming a 28-percent tax rate) based on the average of the annual AFR for mid-term and long-term obligations for the month the building is placed in service.

minimum applicable percentage of nine percent.[303] Similarly, for buildings eligible for four percent credits and placed in service after December 31, 2020, there is a minimum applicable percentage of four percent.[304] (Further details on credit calculations are available in section II.A. of this document, "Low-Income Housing Tax Credit.")

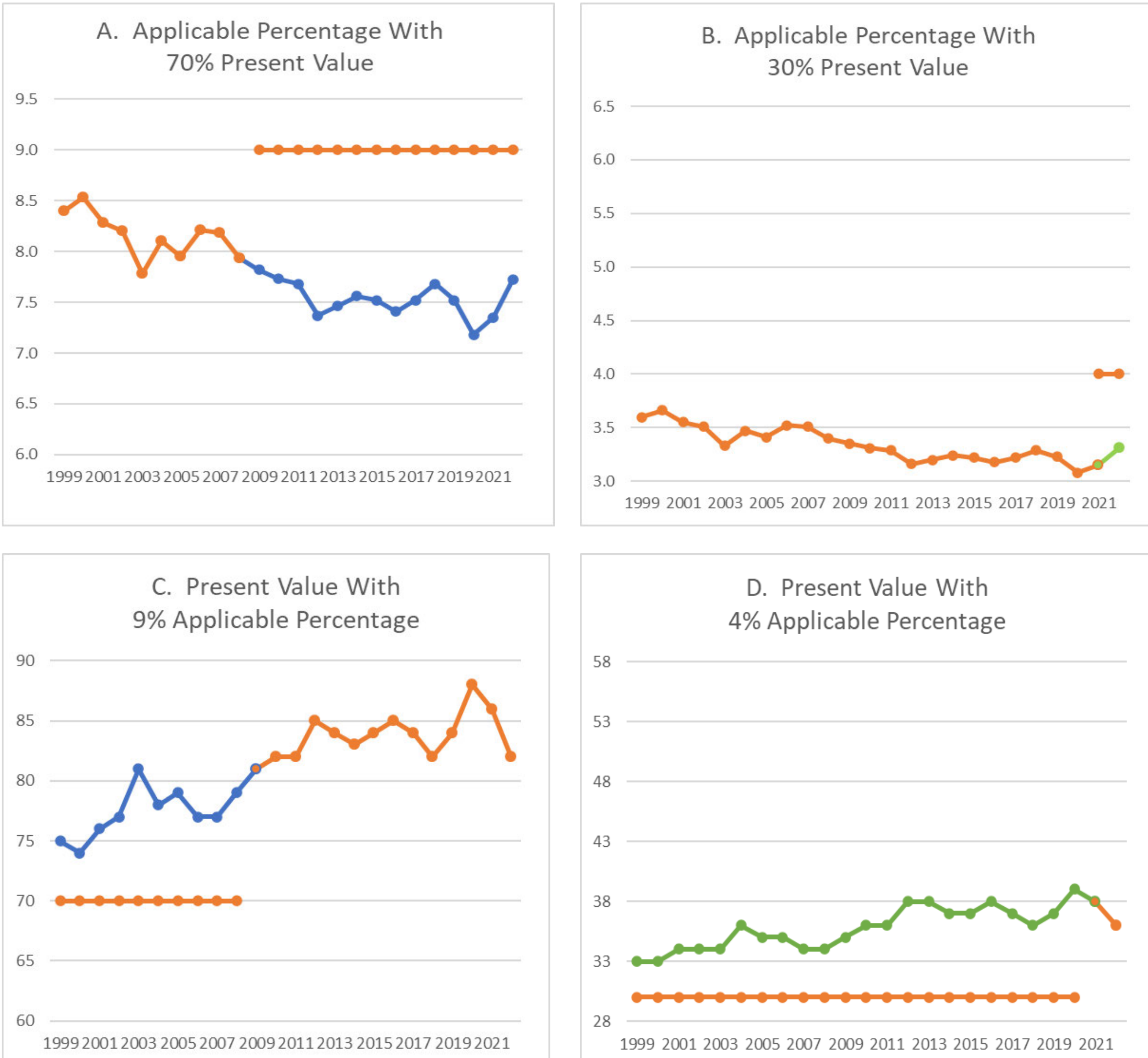
Figure 3 displays changes in the applicable percentages and the present value of the credits between 1999 and 2022. Panels A and C show values for non-Federally subsidized newly constructed housing and non-Federally subsidized substantial rehabilitation. Panels B and D show values for Federally subsidized newly constructed housing, Federally subsidized substantial rehabilitation, and certain housing acquisition costs. Panels A and B show the decline in applicable percentages that yield credits with 70 percent and 30 percent present values to levels below nine percent and four percent, respectively, due to a decline in prevailing interest rates. Similarly, in panels C and D, nine and four percent credit levels result in credits with present values of greater than 70 percent and 30 percent, respectively, again due to changes in prevailing interest rates.

Figure 3 displays applicable percentages and percent present values as determined under law in orange. In 2022, applicable percentages are subject to nine and four percent floors, which result in a stream of low-income housing tax credits with present values of approximately 82 and 36 percent, respectively.

[303] The minimum applicable percentage was temporarily set at nine percent in the Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289. The changes were subsequently extended and then made permanent in the Consolidated Appropriations Act, 2016, Pub. L. No. 114-113.

[304] The minimum applicable percentage was set at four percent in the Consolidated Appropriations Act, 2021, Pub. L. No. 116-260.

Figure 3.–Applicable Percentages and Percent Present Values, 1999-2022



Source: JCT staff calculations. Applicable Federal Rates (AFRs) for July of each year available in various IRS Revenue Rulings.
Note: Data points in orange reflect values in effect according to law.

A low-income housing tax credit is allowable only if the owner of a qualified building receives a housing credit allocation from the State or local housing credit agency. Table 4 reports the allocations of nine-percent credits and four-percent credits from 2001 through 2021. The effect of temporary legislative changes, including an increase in the State housing credit allocations for the nine-percent credit, and a decline in the bond market, which affects the usage of four-percent credits, is evident in 2009. Having represented about three-quarters of all credit allocations on average in prior years, the nine-percent credits represent over 90 percent of all allocations in 2009, before returning to roughly three-quarters of all allocations by 2011.

Table 4.–Low-Income Housing Tax Credit Allocations (millions of dollars)

Year	9 Percent Credits	4 Percent Credits
2001	462.3	137.2
2002	517.2	201.7
2003	573.6	215.2
2004	606.0	216.4
2005	586.5	246.1
2006	730.8	256.0
2007	790.6	315.2
2008	939.9	335.0
2009	1,136.2	93.6
2010	917.4	186.9
2011	749.7	228.3
2012	754.7	196.8
2013	759.9	215.8
2014	775.8	208.9
2015	792.7	297.1
2016	776.4	319.1
2017	916.4	361.0
2018	1,019.9	419.2
2019	1,129.2	501.0
2020	1,120.9	718.3
2021	1,330.1	663.2

Source: State Housing Finance Agencies Factbook: NCHSA Annual Survey Results, Years 2001-2021.

Table 5 reports low-income housing tax credits claimed by corporations[305] on Form 3800 (relating to general business credits) between 2009 and 2019.[306] The majority of investors in LIHTC projects are financial institutions and banks, partly due to various considerations these investments receive in examinations under the Community Reinvestment Act ("CRA").[307] Credits claimed by corporations increased steadily through the period and reached a peak of nearly $10.3 billion in 2019.

Table 5.–Low-Income Housing Tax Credits Claimed by Corporations (millions of dollars)

Year	Credits Claimed
2009	6,730.00
2010	7,035.10
2011	7,083.90
2012	8,092.50
2013	8,485.60
2014	8,895.90
2015	*
2016	9,397.20
2017	9,581.30

[305] In addition to the credits claimed by corporations, a small amount of low-income housing tax credits is claimed by individuals, estates, and trusts. These amounts are not included in the table.

[306] The amounts reported do not reflect the actual tax reduction achieved by taxpayers claiming low-income housing tax credits, as the actual tax reduction depends upon whether the taxpayer had net operating losses, is subject to the alternative minimum tax (repealed for corporations after 2017), and other factors specific to each taxpayer's situation. For taxable years beginning after December 31, 2022, C corporations meeting certain requirements are subject to a new corporate alternative minimum tax that is based on adjusted financial statement income. See secs. 55(b)(2), 56A and 59(k). General business credits, including the low-income housing tax credit, generally may offset up to approximately 75 percent of the sum of a corporation's normal income tax and alternative minimum tax. Any general business credit in excess of this limitation generally may be carried back one year and forward up to 20 years. See secs. 38 and 39.

[307] Mark P. Keightley, *An Introduction to the Low-Income Housing Tax Credit* (Report RS22389), June 23, 2022, p. 6, available at https://sgp fas.org/crs/misc/RS22389.pdf. For more information on the LIHTC program and the CRA, see Office of the Comptroller of the Currency, *Low-Income Housing Tax Credits: Affordable Housing Investment Opportunities for Banks*, Washington DC, April 2014, https://www.occ.gov/publications-and-resources/publications/community-affairs/community-developments-insights/ca-insights-mar-2014.html.

Year	Credits Claimed
2018	9,887.13
2019	10,258.79

* Data are unavailable.

Source: IRS Statistics of Income Corporate Files, various years.

Rehabilitation tax credit

Table 6 reports the total amount of rehabilitation tax credits claimed by corporations[308] in 2019.[309] The data represent claims by corporations for both the credit for certified historic structures and the credit for pre-1936 buildings other than historic structures. These data may not be comparable to data prior to 2018 due to changes in law since 2018. For more on these changes and a discussion of present law, see section II.B. of this document, "Rehabilitation Tax Credit."

Table 6.–Rehabilitation Tax Credits Claimed by Corporations, 2019
(thousands of dollars)

Pre-1936 buildings[1]	Certified historic structures	Total
13,517	1,009,892	1,023,409

[1] This data represents pre-1936 buildings as allowed under rules prior to 2018.
Source: IRS Statistics of Income, 2022.

[308] In addition to the tax credits claimed by corporations, a small amount of rehabilitation tax credits is claimed by individuals, estates, and trusts. These amounts are not included in the table.

[309] The amounts reported do not reflect the actual tax reduction achieved by taxpayers claiming rehabilitation tax credits, as the actual tax reduction depends upon whether the taxpayer has net operating losses, is subject to the alternative minimum tax (repealed for corporations after 2017), and other factors specific to the taxpayer's situation.

Tax expenditure estimates

Table 7 contains tax expenditure estimates for select tax provisions related to rental housing.[310] Estimates are shown for the total tax expenditure for fiscal years 2022-2026.[311] The largest tax expenditure related to rental housing is the low-income housing tax credit, with a tax expenditure estimate of $65.0 billion. Approximately $64.1 billion of the $65.0 billion is attributable to corporations. The next largest item, accelerated depreciation of rental housing, is available regardless of whether the rental housing is subject to tenant income restrictions. The estimated tax expenditure is about half as large at $29.4 billion, while the exclusion of interest on State and local government qualified private activity bonds for rental housing is $5.9 billion. In contrast to the low-income housing tax credit, most of the tax expenditure for these provisions ($25.6 billion, and $4.6 billion, respectively) is attributable to individuals.

Table 7.–Select Tax Expenditures for Housing, Fiscal Years 2022-2026

Tax Expenditure	Total Amount (billions of dollars)
Credit for low-income housing	65.0
Depreciation of rental housing in excess of alternative depreciation system	29.4
Exclusion of interest on State and local government qualified private activity bonds for rental housing	5.9

Source: Joint Committee on Taxation staff.

[310] A tax expenditure estimate is not the same as a revenue estimate for the repeal of the tax expenditure provision. First, unlike revenue estimates, tax expenditure estimates do not incorporate the effects of the behavioral changes that are anticipated to occur in response to the repeal of a tax expenditure provision, other than simple additions or deletions in filing tax forms, or what the Joint Committee staff refers to as "tax form behavior." Second, tax expenditure calculations are concerned with changes in the reported tax liabilities of taxpayers without concern for the short-term timing of tax payments, whereas revenue estimates are concerned with changes in Federal government tax receipts that are affected by the timing of all tax payments. Third, tax expenditure estimates reflect only the income tax effects of provisions. A revenue estimate would consider interactions between the income tax and other Federal taxes such as payroll, excise, and the estate and gift taxes.

[311] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2022*-2026 (JCX-22-22), December 22, 2022.