PRESENT LAW FOR CERTAIN HOUSING TAX BENEFITS

Scheduled for a Public Hearing
Before the
SUBCOMMITTEE ON SELECT REVENUE MEASURES
of the
HOUSE COMMITTEE ON WAYS AND MEANS
on May 24, 2007

By the Staff
of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Subcommittee on Select Revenue Measures of the House Committee on Ways and Means has scheduled a public hearing for Thursday, May 24, 2007, on improving coordination of certain housing tax benefits. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present law relating to the low-income housing credit (sec. 42 of the Internal Revenue Code), tax-exempt bonds for rental housing (sec. 142), and tax-exempt bonds for owner-occupied housing (sec. 143).

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[1] This document may be cited as follows: Joint Committee on Taxation, "*Present Law for Certain Housing Tax Benefits*" (JCX-28-07), May 23, 2007. This publication is also available on the web at www.house.gov/jct.

A. Low-Income Housing Credit

Present Law

In general

The low-income housing credit may be claimed over a 10-year period by owners of certain residential rental property for the cost of rental housing occupied by tenants having incomes below specified levels (sec. 42).[2] The amount of the credit for any taxable year in the credit period is the applicable percentage of the qualified basis of each qualified low-income building. The qualified basis of any qualified low-income building for any taxable year equals the applicable fraction of the eligible basis of the building.

Applicable percentage

The credit percentage for newly constructed or substantially rehabilitated housing that is not Federally subsidized is adjusted monthly by the Internal Revenue Service (the, "IRS") so that the 10 annual installments have a present value of 70 percent of the total qualified basis (the "70-percent credit"). The credit percentage for newly constructed or substantially rehabilitated housing that is Federally subsidized and for existing housing that is substantially rehabilitated is calculated to have a present value of 30 percent of the total qualified basis (the "30-percent credit"). The credit percentages are set for the earlier of: (1) the month the building is placed in service; or (2) at the election of the taxpayer, (a) the month the taxpayer and the housing credit agency enter into a binding agreement with respect to such building for a credit allocation, or (b) in the case of a tax-exempt bond-financed project for which no credit allocation is required, the month in which the tax-exempt bonds are issued. These credit percentages are adjusted monthly by the IRS on a discounted after-tax basis (assuming a 28-percent tax rate) based on the average of the Applicable Federal Rates for mid-term and long-term obligations for the month the building is placed in service. The discounting formula assumes that each credit is received on the last day of each year and that the present value is computed on the last day of the first year. In a project consisting of two or more buildings placed in service in different months, a separate credit percentage may apply to each building.

Definition of Federally subsidized

In general, any newly constructed or substantially rehabilitated building is treated as Federally subsidized for any taxable year if, at any time during such taxable year or prior taxable year, there is or was outstanding any obligation the interest of which is exempt under section 103, or any below market Federal loan, the proceeds of which are or were used (directly or indirectly) with respect to such building or the operation thereof. Exceptions are provided from this general rule: (1) if the taxpayer elects to reduce eligible basis; and (2) for certain subsidized construction financing. For purposes of this rule, a below market Federal loan generally is

[2] Special rules may apply in the case of certain Hurricane-related disaster areas. See Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 109th Congress (JCS-1-07), January 17, 2007, Part 9.

defined as a loan funded, in whole or in part, with Federal funds if the interest payable on such loan is less than the applicable Federal rate in effect under section 1274(d)(1) (as of the date the loan was made). A loan is not treated as a below market Federal loan for these purposes if it is below market solely by reason of assistance provided under sections 106, 107, or 108 of the Housing and Community Development Act of 1974, as in effect on December 19, 1989 (the date of enactment of the Omnibus Budget Reconciliation Act of 1989).

Qualified basis

The qualified basis of any qualified low-income building for any taxable year equals the applicable fraction of the eligible basis of the building.

The applicable fraction is the smaller of: (1) the unit fraction; or (2) the floor space fraction. The unit fraction is determined as the proportion of the low-income units in the building to the total number of residential units in the building. The floor space fraction is determined as the proportion of the total floor space of the low-income units in the building to the total floor space of all the residential units in the building. In some cases, qualified basis may also include a portion of the building used to provide supportive services for the homeless as long as that portion is not in excess of 20 percent of the qualified basis of the building. Other special rules apply to additions to qualified basis arising after the initial determination of qualified basis.

The eligible basis of a building generally is its adjusted basis as of the close of the first taxable year of the credit period. It usually consists of: (1) the cost of new construction; (2) the cost of rehabilitation; or (3) the cost of acquisition of an existing building acquired by purchase (including certain costs of rehabilitation, if any). With certain exceptions,[3] the eligible basis of a building acquired by purchase is zero unless there has not been a period of at least 10 years between the acquisition by purchase and the later of the date the building was last placed in service or the date of the most recent nonqualified substantial improvement of the building (e.g., improvements equaling at least 25 percent of the adjusted basis of the building before such improvements).

Generally, only the adjusted basis of the depreciable property may be included in eligible basis. The cost of land is not included in eligible basis.

Generally, eligible basis may not include in any taxable year the amount of any Federal grant, regardless of whether such grant is included in gross income. A Federal grant includes any grant funded, in whole or in part, by the Federal government, to the extent funded with Federal funds. Examples of grants that may not be included in eligible basis include grants

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[3] The Internal Revenue Service may waive the 10-year requirement for any building substantially assisted, financed, or operated under Housing and Urban Development ("HUD") section 8, section 221(d)(3), or section 236 programs, or under the Farmers' Home Administration section 515 program where an assignment of the mortgage secured by the property in the project to HUD or the Farmers' Home Administration otherwise would occur or when a claim against a Federal mortgage insurance fund would occur.

funded by Community Development Block Grants, Urban Development Action Grants, Rental Rehabilitation Grants, and Housing Development Grants.

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

A qualified low-income building is a building subject to the 15-year compliance period and 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 that buildings comprising the project are subject to the 15-year compliance period. A qualified low-income housing project includes a qualified low-income building containing residential rental units and also contains other property that is functionally related and subordinate to the function of providing residential rental units. A project may include multiple buildings having similarly constructed housing units, provided: (1) the buildings are located on the same tract of land; (2) are owned by the same person for Federal income tax purposes; and (3) are financed pursuant to a common plan of financing.

Residential rental units must be for use by the general public, and all of the units in a project must be used on a nontransient basis. For these purposes, use by the general public, does not include the case were the residential rental units are: (1) provided only for members of a social organization; or (2) are provided by an employer for its employees. Generally, a unit is considered to be used on a nontransient basis if the initial lease term is six months or greater. Additionally, no hospital, nursing home, sanitarium, lifecare facility, dormitory, trailer park or, retirement home providing significant services other than housing may be a qualified low-income project. Factory made housing that is permanently fixed to real property may be a qualified low-income building.

Unlike the requirements for units in projects financed with tax-exempt bonds, certain single room occupancy housing used on a nontransient basis may qualify for the credit, even though such housing may provide eating, cooking, and sanitation facilities on a shared basis. An example of housing that may qualify for the credit is a residential hotel used on a nontransient basis that is available to all members of the public.

Income targeting

In order to be eligible for the low-income housing credit, a qualified low-income building must be part of a qualified low-income housing project. In general, a qualified low-income housing project is defined as a project that satisfies one of two tests at the election of the taxpayer. The first test is met if 20 percent or more of the residential units in the project are both rent-restricted, and occupied by individuals whose income is 50 percent or less of area median gross income (the “20-50 test”). The second test is met if 40 percent or more of the residential units in such project are both rent-restricted, and occupied by individuals whose income is 60 percent or less of area median gross income (the “40-60 test”). These income figures are adjusted for family size.

Gross rent limitation

Maximum rents that may be charged families in units on which a credit is claimed depend on the number of bedrooms in the unit. The rent limitation is 30 percent of the qualifying income of a family deemed to have a size of 1.5 persons per bedroom (for example, a two-bedroom unit has a rent limitation based on the qualifying income for a family of three).

The gross rent limitation applies only to payments made directly by the tenant. Any rental assistance made on behalf of the tenant, such as through section 8 of the United States Housing Act of 1937 or any comparable Federal rental assistance, is not included in gross rent. Also, any comparable State or local rental assistance is not included in gross rent.

Compliance period and penalty for noncompliance

Qualified residential rental projects must remain as rental property and must satisfy the minimum set aside requirement, described above, throughout a prescribed compliance period. Low-income units comprising the qualified basis on which additional credits are based are required to comply continuously with all requirements in the same manner as units satisfying the minimum set aside requirement. Units, in addition to those meeting the minimum set aside requirement on which a credit is allowable, also must continuously comply with this requirement.

The compliance period for any building is the period beginning on the first day of the first taxable year of the credit period of such building and ending 15 years from such date. The minimum set aside requirement must be met, in all cases, by the close of the first year of the compliance period.

Following the close of the first taxable year for which the credit is claimed and annually thereafter during the compliance period, the taxpayer must certify to the Secretary of the Treasury that the project has continuously complied throughout the year with the set aside requirement and report the dollar amount of the qualified basis of the building and the maximum applicable percentage and qualified basis permitted to be taken into account by the housing credit agency. Additionally, the certification must include the date (including the taxable year) in which the building was placed in service and any other information required by the U.S. Department of the Treasury.

The penalty for any building subject to the 15-year compliance period failing to remain part of a qualified low-income project (due, for example, to noncompliance with the minimum set aside requirement, or the gross rent requirement, or other requirements with respect to the units comprising the set aside) is recapture of the accelerated portion of the credit, with interest, for all prior years.

Generally, any change in ownership by a taxpayer of a building subject to the compliance period is also a recapture event. An exception is provided if the seller satisfies certain bond posting requirements (in an amount and manner prescribed by Treasury), and if it can reasonably be expected that such building will continue to be operated as a qualified low-income building for the remainder of the compliance period. For a partnership consisting of 35 or more partners (unless the partnership elects not to be treated as the taxpayer), no change in ownership will be deemed to occur provided within a 12 month period at least 50 percent (in value) of the ownership is unchanged.[4]

In the year of a recapture event, no credit is allowable for the taxpayer that is subject to recapture. Additionally, the accelerated portion of credits paid in earlier years is recaptured with interest, from the date the recaptured amount was claimed, at the overpayment rate established under section 6621. The accelerated portion of the credit in any year is the amount of credits determined for the year, less the amount that would have been determined for the year if all credits had been allowed ratably over the 15-year compliance period (with no further discounting). Because credits on the initial qualified basis of a building are claimed ratably over a 10-year credit period, rather than the 15-year compliance period, the amount of credit recaptured for noncompliance during the first 11 years is one third of the credit determined for the year, plus interest. In the absence of additions to qualified basis and previous recapture events, the credits are recaptured in the following amounts (in addition to interest): one-third for violations after year one and before expiration of year 11; four-fifteenths for violations after year 11 but before expiration of year 12; three-fifteenths for violations after year 12 but before expiration of year 13; two-fifteenths for violations after year 13 but before expiration of year 14; and one-fifteenth for violations after year 14 but before expiration of year 15.

Because credits claimed on additions to qualified basis are paid ratably over the remainder of the compliance period (the credit percentage is two-thirds of the otherwise applicable percentage), there is no accelerated portion of credits attributable to additions to qualified basis and, therefore, no recapture of these amounts.

Credit eligibility also depends on the existence of a 30-year extended low-income use agreement for the property. The 30-year extended use agreement creates a State-law right to enforce low-income use for an additional 15 years after the initial 15-year recapture period.

Credit cap

A low-income housing credit is allowable only if the owner of a qualified building receives a housing credit allocation from the State or local housing credit agency. Generally, the aggregate credit authority provided annually to each State for calendar year 2007 is $1.95 per resident, with a minimum annual cap of $2,275,000 for certain small population States. These amounts are indexed for inflation. These limits do not apply in the case of projects that also receive financing with proceeds of tax-exempt bonds issued subject to the private activity bond volume limit.

Carryover allocation rule

In general, the allocation of the low-income housing credit must be made not later than the close of the calendar year in which the building is placed in service. One exception to this rule is a carryover allocation. In a carryover allocation, an allocation may be made to a building

[4] The presence of corporate partners does not disqualify the partnership from this special exception provided the partnership is at least 50 percent owned by at least 35 individual taxpayers.

that has not yet been placed in service, provided that: (1) more than 10 percent of the taxpayer's reasonably expected basis in the project (as of the close of the second calendar year following the calendar year of the allocation) is incurred as of the later of six months after the allocation is made or the end of the calendar year in which the allocation is made; and (2) the building is placed in service not later than the close of the second calendar year following the calendar year of the allocation.

Enhanced credit

Generally, buildings located in high cost areas (i.e., qualified census tracts and difficult development areas) are eligible for an enhanced credit. Under the enhanced credit, the 70-percent and 30-percent credit is increased to a 91-percent and 39-percent credit, respectively. The mechanism for this increase is through an increase from 100 to 130 percent of the otherwise applicable eligible basis of a new building or the rehabilitation expenditures of an existing building. A further requirement for the enhanced credit is that no more than 20 percent of the population of each metropolitan statistical area or nonmetropolitan statistical area may be a difficult to develop area.

State allocation plans

Each State must develop a plan for allocating credits, and such plan must include certain allocation criteria including: (1) project location; (2) housing needs characteristics; (3) project characteristics (including whether the project uses existing housing as part of a community revitalization plan; (4) sponsor characteristics; (5) tenant populations with special needs; (6) tenant populations of individuals with children; and (7) projects intended for eventual tenant ownership. The State allocation plan must also give preference to housing projects: (1) that serve the lowest income tenants; (2) that are obligated to serve qualified tenants for the longest periods; and (3) that are located in qualified census tracts and the development of which contributes to a concerted community revitalization plan. For this purpose, a qualified census tract is defined as a census tract: (1) designated by the Secretary of HUD; and (2) for the most recent year for which census data is available for such tract, either 50 percent or more of the households have a income that is less than 60 percent of the area median income for that year or which has a poverty rate of at least 25 percent.

Present law also requires that housing credit agencies perform a comprehensive market study of the housing needs of the low-income individuals in the area to be served by the project and a written explanation, available to the general public, for any allocation not made in accordance with the established priorities and selection criteria of the housing credit agency. It also requires that the housing credit agency conduct site visits to monitor for compliance with habitability standards.

Rehabilitation credit

The basis of a building for purposes of the low-income credit is reduced by the amount of the rehabilitation tax credit allowed for rehabilitation expenditures with respect to the building.

Present law provides a two-tier credit for rehabilitation expenditures (sec. 47).[5] A 20-percent credit is provided for rehabilitation expenditures with respect to a certified historic structure. A 10-percent credit is provided for rehabilitation expenditures with respect to buildings that were first placed in service before 1936, and that meet other requirements relating to (1) retention of certain walls and structures, (2) substantial rehabilitation, and (3) placement in service before rehabilitation.

Depreciation

The basis of property, for purposes of depreciation, is not reduced by the amount of low-income credits claimed. Residential rental property, including low-income credit property, is depreciated using the straight-line method over a 27.5 year recovery period (sec. 168).

Limitation on credit

Under present law, the low-income housing credit is part of the general business tax credit. The general business tax credit generally may not exceed the excess of the taxpayer's income tax liability over the tentative minimum tax (or, if greater, 25 percent of the regular tax liability in excess of $25,000). Thus, the low-income housing credit may not offset the alternative minimum tax.

Credits in excess of the credit limitation may be carried back one year and carried forward for up to 20 years.

[5] Special rules may apply in the case of certain Hurricane-related disaster areas. See Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 109th Congress (JCS-1-07), January 17, 2007, Part 9.

B. Tax Exempt Bonds For Owner-Occupied and Rental Housing

Present Law

In general

Under present law, gross income generally does not include interest paid 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 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 may be issued to finance owner-occupied housing and residential rental property.[6]

Owner-occupied housing

Owner-occupied housing may be financed with the proceeds of qualified mortgage bonds (sec. 143).[7] 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. The Code imposes several limitations on qualified mortgage bonds, including income limitations for homebuyers, and purchase price limitations for the homes financed with bond proceeds. The income limitations are satisfied if all the financing provided by an issue is provided for mortgagors whose family incomes do not exceed 115 percent of the median family income for the metropolitan area or State, whichever is greater, in which the financed residences are located. 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 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).

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. For targeted area residences, the income limitation is satisfied when no more than one-third of the mortgages are made without regard to any income limits and the remainder of the

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[6] Special rules may apply in the case of certain Hurricane-related disaster areas. See Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 109th Congress (JCS-1-07), January 17, 2007, Part 7 and Part 9.

[7] Special rules may apply in the case of qualified veterans' mortgage bonds (sec. 143(l)).

mortgages are 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. 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. Under present law, qualified home-improvement loans generally may not exceed $15,000.

All or part of the interest subsidy provided by qualified mortgage bonds is recaptured if the borrower experiences substantial increases in income and disposes of the subsidized residence within nine years after purchase.

Residential rental property

Residential rental property may be financed with qualified private activity bonds if the financed project is a "qualified residential rental project" (sec. 142). 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 qualified residential rental projects must certify annually that such project meets the requirements for qualification, including meeting the 20-50 test or the 40-60 test.

Volume limitations on private activity bonds

As with most qualified private activity bonds, issuance of qualified mortgage bonds and qualified private activity bonds for residential rental property is subject to annual State volume limitations (the "State volume cap"). For calendar year 2007, the State volume cap, which is indexed for inflation, equals $85 per resident of the State, or $256.24 million, if greater. Exceptions from the State volume cap are provided for bonds issued for certain governmentally owned facilities (airports, ports, high-speed intercity rail, and solid waste disposal) and bonds that are subject to separate local, State, or national volume limits (public/private educational facilities, enterprise zone facility bonds, qualified green building/sustainable design projects, and qualified highway or surface freight transfer facility bonds).

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") (sec. 25(c)(2). 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, a 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 carry-forward is not permitted for amounts in excess of the $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 (sec. 25(i)).

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.

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.