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TECHNICAL EXPLANATION OF DIVISION C OF H.R. 3221, THE “HOUSING ASSISTANCE TAX ACT OF 2008” AS SCHEDULED FOR CONSIDERATION BY THE HOUSE OF REPRESENTATIVES ON JULY 23, 2008

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a technical explanation of Division C of H.R. 3221, the "Housing Assistance Tax Act of 2008," as scheduled for consideration by the House of Representatives on July 23, 2008.

[1] This document may be cited as follows: Joint Committee on Taxation, *Technical Explanation of Division C of H.R. 3221, the "Housing Assistance Tax Act of 2008," as Scheduled for Consideration by the House of Representatives on July 23, 2008* (JCX-63-08), July 23, 2008. This publication can be found on the internet at www.jct.gov.

I. EXPLANATION OF THE BILL

TITLE I – BENEFITS FOR MULTI-FAMILY LOW-INCOME HOUSING

Overview

Low-income housing credit

The low-income housing credit may be claimed over a 10-year period for the cost of building rental housing occupied by tenants having incomes below specified levels. 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.

The credit percentage for newly constructed or substantially rehabilitated housing that is not Federally subsidized is adjusted monthly by the Internal Revenue Service so that the 10 annual installments of the credit have a present value of 70 percent of the total qualified basis. 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 qualified basis. These are referred to as the 70-percent credit and 30-percent credit, respectively.

Tax-exempt bonds for housing

Private activity bonds are bonds that nominally are issued by State or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such private person. 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, qualified mortgage bonds, qualified veterans' mortgage bonds, and bonds for 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." 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 annually certify that such project meets the requirements for qualification, including meeting the 20-50 test or the 40-60 test.

A. Low-Income Housing Credit

1. Temporary increase in the low-income housing credit volume limits (sec. 3001 of the bill and sec. 42 of the Code)

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). 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.

Volume limits

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 2008 is $2.00 per resident, with a minimum annual cap of $2,325,000 for certain small population States (Rev. Proc. 2007-66). These amounts are indexed for inflation. Projects that also receive financing with proceeds of tax-exempt bonds issued subject to the private activity bond volume limit do not require an allocation of the low-income housing credit.

Explanation of Provision

The provision increases from $2.00 per resident to $2.20 per resident the allocation authority provided annually to each State for calendar years 2008 and 2009. Also, the provision increases the minimum annual cap for certain small population States by ten percent of the otherwise available amounts in 2008 and 2009, respectively. In 2010, the volume limits will return to the prescribed levels had this provision not been enacted.

Effective Date

The provision is effective for low-income credit allocations made for calendar years after 2007.

2. Determination of credit rate (sec. 3002 of the bill and sec. 42 of the Code)

(a) Modifications to the applicable percentage

Present Law

In general

The low-income housing credit may be claimed over a 10-year credit period after each low-income building is placed-in-service. 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.

Present value credit

The calculation of the applicable percentage is designed to produce a credit equal to: (1) 70 percent of the present value of the building's qualified basis in the case of newly constructed or substantially rehabilitated housing that is not Federally subsidized (the "70-percent credit"); or (2) 30 percent of the present value of the building's qualified basis in the case of newly constructed or substantially rehabilitated housing that is Federally subsidized and existing housing that is substantially rehabilitated (the "30-percent credit"). Where existing housing is substantially rehabilitated, the existing housing is eligible for the 30-percent credit and the qualified rehabilitation expenses (if not Federally subsidized) are eligible for the 70-percent credit.

Calculation of the applicable percentage

The credit percentage for a low-income building is 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 (used for the 70-percent credit and 30-percent credit) 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.

Explanation of Provision

The provision provides a temporary applicable percentage of 9 percent for newly constructed non-Federally subsidized buildings placed in service after the date of enactment and before December 31, 2013.

Effective Date

The provision is effective for buildings placed in service after the date of enactment.

(b) Modification to the definition of a Federally subsidized building

Present Law

If any portion of the eligible basis of a building is Federally subsidized, then the building is ineligible for the 70-percent credit. A Federal subsidy is defined as: (1) any obligation the interest of which is tax exempt from tax under section 103; (2) a direct or indirect Federal loan if the interest rate is less than the applicable Federal rate; or (3) assistance provided under the HOME Investments Partnership Act or the Native American Housing Assistance and Self Determination Act of 1996 if certain requirements are not met.

Explanation of Provision

The provision limits the definition of a Federal subsidy for these purposes to any obligation the interest on which is exempt from tax under section 103. Therefore, additional buildings may become eligible for the 70-percent credit.

Effective Date

The provision is effective for buildings placed in service after the date of enactment.

3. Modifications to definition of eligible basis (sec. 3003 of the bill and sec. 42 of the Code)

(a) Modification to the enhanced credit for buildings in high-cost areas

Present Law

Generally, buildings located in two types of 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 credits are 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 the portions of each metropolitan statistical area or nonmetropolitan statistical area designated as difficult to develop areas cannot exceed an aggregate area having 20 percent of the population of such statistical area.

Explanation of Provision

The provision adds a third type of high-cost area eligible for an enhanced credit. The third type is defined as any building designated by the State housing credit agency as requiring the enhanced credit in order for such building to be financially feasible. This new type of high-cost area is not subject to the present-law limitation limiting high cost areas to 20 percent of the population of each metropolitan statistical area or nonmetropolitan statistical area.

It is expected that the State allocating agencies shall set standards for determining which areas shall be designated difficult development areas and which projects shall be allocated additional credits in such areas in the State allocating agency's allocation plan. It is also expected that the State allocating agency shall publicly express its reasons for such area designations and the basis for allocating additional credits to a project.

Effective Date

The provision is effective for buildings placed in service after the date of enactment.

(b) Modification to the substantial rehabilitation requirement

Present Law

Rehabilitation expenditures[2] paid or incurred by a taxpayer with respect to a low-income building are treated as a separate building and may be eligible for the 70-percent credit if they satisfy the otherwise applicable credit rules.[3] To qualify for the credit, the rehabilitation expenditures must equal the greater of an amount that is (1) at least 10 percent of the adjusted basis of the building being rehabbed; or (2) at least $3,000 per low-income unit in the building being rehabbed.

At the election of the taxpayer, a special rule applies allowing the 30-percent credit to both existing buildings and rehabilitation expenditures if the second prong (i.e., at least $3,000 of rehabilitation expenditures per low-income unit) of the rehabilitation expenditures test is satisfied. This special rule applies only in the case where the taxpayer acquired the building and immediately prior to that acquisition the building was owned by or on behalf of a government unit.

Explanation of Provision

The provision increases the minimum expenditure requirements. Under the provision, the rehabilitation expenditures must equal the greater of an amount that is (1) at least 20 percent of the adjusted basis of the building being rehabbed; or (2) at least $6,000 per low-income unit in the building being rehabbed. The provision also indexes the $6,000 amount for inflation. The other present-law rules apply.[4]

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[2] Rehabilitation expenditures are amounts chargeable to a capital account and incurred for property (or additions or improvements to property) of a character subject to the allowance for depreciation in connection with the rehabilitation of a building. Such term does not include the cost of acquiring the building (or any interest therein). Other rules apply.

[3] The credit period for an existing building does not begin before the credit period for the rehabilitation expenditures.

[4] A present-law rule reduces the $3,000 amount to $2,000 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 USDA Rural Development section 515 program where an assignment

The provision retains the taxpayer election allowing the 30-percent credit to both existing building and the rehabilitation expenditures if the second prong (i.e., at least $6,000 of rehabilitation expenditures per low-income unit) of the rehabilitation expenditures test is satisfied.

Effective Date

The provision is effective for buildings which receive credit allocations after the date of enactment and substantially tax-exempt bond financed buildings (which satisfy the requirements of section 42(h)(4) and therefore do not require a credit allocation) which receive a tax-exempt bond allocation after the date of enactment.

(c) Community service facility eligibility for the credit

Present Law

In general, the qualified basis of a low-income building is limited to that portion of the building dedicated to qualified low-income use (either living space or certain common areas). However certain "community service facilities" used by non-tenants of the low-income building may be included in the qualified basis of the low-income building if certain requirements are satisfied. For this purpose, a community service facility: (1) means any facility to serve primarily individuals whose income is 60 percent or less of area median income; and (2) may not exceed 10 percent of the eligible basis of the qualified low-income housing credit project of which it is a part.

Explanation of Provision

The provision expands the size of the community service facility with respect to which the low-income housing credit may be claimed. Under the provision the size of the community service facility may not exceed the sum of: (1) 25 percent of so much of the eligible basis of the qualified low-income housing credit project of which it is a part as does not exceed $15,000,000; and (2) 10 percent of any excess over $15,000,000 of the eligible basis of the qualified low-income housing credit project of which it is a part.

Effective Date

The provision is effective for buildings placed in service after the date of enactment.

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of the mortgage secured by the property in the project to HUD or the USDA Rural Development otherwise would occur or when a claim against a Federal mortgage insurance fund would occur. A conforming change is made by the provision so that that the $2,000 amount will be increased to two-thirds of the $6,000 amount as indexed.

(d) Clarification of the treatment of Federal grants

Present Law

The compliance period for any low-income credit building is the period of fifteen taxable years beginning with the taxable year in which the building is placed in service, or at the election of the taxpayer the succeeding taxable year. If during any year of the compliance period, a grant is made with respect to any building or the operation thereof and any portion of the grant is funded with Federal funds, the eligible basis of the building must be reduced by the portion of the grant that is Federally-funded. This basis reduction must be made for the taxable year in which the grant is made and all succeeding taxable years.

Explanation of Provision

The provision clarifies the basis reduction rule to apply to Federally-funded grants received before the compliance period. It also provides that no basis reduction is required for Federally-funded grants to enable the property to be rented to low-income tenants received during the compliance period if those grants do not otherwise increase the taxpayer's eligible basis in the building.

The provision also directs the modification of section 1.42-16(b) of the Treasury regulations to provide that none of the following shall be considered a grant made with respect to a building or its operation for purposes of section 42(d)(5)(A) of the Internal Revenue Code of 1986: (1) rental assistance under section 521 of the Housing Act of 1949 (42 U.S.C. 1490a); (2) assistance under section 538(f)(5) of the Housing Act of 1949 (42 U.S.C. 1490p-2(f)(5)); (3) interest reduction payments under section 236 of the National Housing Act (12 U.S.C. 1715z-1); (4) rental assistance under section 202 of the Housing Act of 1959 (12 U.S.C. 1701q); (5) rental assistance under section 811 of the Cranston-Gonzalez National Affordable Housing Act (42 U.S.C. 8013); (6) modernization, operating, and rental assistance pursuant to section 202 of the Native American Housing Assistance and Self-Determination Act of 1996 (25 U.S.C. 4132); (7) assistance under title IV of the Stewart B. McKinney Homeless Assistance Act (42 U.S.C. 11361 et seq.); (8) tenant-based rental assistance under section 212 of the Cranston-Gonzalez National Affordable Housing Act (42 U.S.C. 12742); (9) assistance under the AIDS Housing Opportunity Act (42 U.S.C. 12901 et seq.); (10) per diem payments under section 2012 of title 38, United States Code; (11) rent supplements under section 101 of the Housing and Urban Development Act of 1965 (12 U.S.C. 1701s); (12) assistance under section 542 of the Housing Act of 1949 (42 U.S.C. 1490r); and (13) any other ongoing payment used to enable the property to be rented to low-income tenants. Further, no basis reduction is required for loans (regardless of interest rate) made to owners of qualified low-income housing projects from the proceeds of Federally-funded grants. Nothing contained in this direction to modify the regulations is intended to create any inference with respect to the consideration of any program specified under subsection (a) of a grant made with respect to a building or its operation for purposes of section 42(d)(5)(A) of the Internal Revenue Code of 1986 as in effect on the day before such date of enactment.

Effective Date

The provision is effective for buildings placed in service after the date of enactment.

(e) Modification to the definition of related persons

Present Law

With certain exceptions,[5] the eligible basis of an existing building is zero for low-income housing credit purposes unless: (1) the building was acquired by purchase; (2) there has 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); and (3) the building was not previously placed-in-service by the taxpayer or a related person (sec. 42(d)(2)(B)). In order for a building to be acquired by purchase, it may not be acquired from a related party.

The definition of related persons for purposes of these rules is the same as the definition used in sections 267(b) and 707(b)(1) (relating to the disallowance of losses) with one modification.[6] Under the modification, in determining whether two persons are related, "10 percent" is substituted for "50 percent" in determining the threshold level of ownership in certain partnerships and corporations. For example, under the low-income credit provision, two partnerships are related if the same persons own more than ten percent of the capital interests or profits interest in each partnership.

Explanation of Provision

The provision repeals the ten-percent attribution rule used to determine whether parties are related for purposes of determining whether an existing building qualifies for the low-income housing credit. Under the provision, two persons are related for this purpose if they bear a relationship to each other specified in sections 267(b) or 707(b)(1).

Effective Date

The provision is effective for buildings placed in service after the date of enactment.

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[5] 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.

[6] In addition, certain businesses under common control are related persons for purposes of these rules.

(f) Exception to 10-year period rule related to prior placement in service of certain buildings

Present Law

In general the low income housing credit is not allowed with respect to existing buildings unless there was a period of at least ten years between the date of it's acquisition by the taxpayer 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 buildings (the "ten-year" rule").

Under one exception from this general rule, the Secretary of the Treasury (after consultation with the appropriate Federal official) may waive the ten-year rule with respect to any Federally-assisted building if such waiver is necessary: (1) to avert an assignment of the mortgage secured by property in the project (of which the building is a part) to the Department of Housing and Urban Development or the Farmers Home Administration, or (2) to avert a claim against a Federal mortgage insurance fund (or such department or Administration) with respect to a mortgage which is so secured. For these purposes a Federally-assisted building is any building which is substantially assisted, financed, or operated under: (1) section 8 of the United States Housing Act of 1937; (2) section 221(d)(3) or 236 of the National Housing Act; or (3) section 515 of the Housing Act of 1949, as such Acts are in effect on the date of the enactment of the Tax Reform Act of 1986.

Also, a waiver may be granted with respect to certain Federally-assisted building if; (1) the mortgage on such building is eligible for prepayment under subtitle B of the Emergency Low Income Housing Preservation Act of 1987 or under section 502(c) of the Housing Act of 1949 at any time within one year after the date of the application for such waiver; (2) the appropriate Federal official certifies to the Secretary of the Treasury that it is reasonable to expect that, if the waiver is not granted, such building will cease complying with its low-income occupancy requirements; and (3) the eligibility to prepay such mortgage without the approval of the appropriate Federal official is waived by all persons who are so eligible and such waiver is binding on all successors of such persons. For purposes of this rule a Federally-assisted building is a building which is substantially assisted, financed, or operated under: (1) section 221(d)(3) or 236 of the National Housing Act; or (2) section 515 of the Housing Act of 1949, as such Acts are in effect on the date of the enactment of the Tax Reform Act of 1986). An appropriate Federal official means, for these purposes, the Secretary of Housing and Urban Development (in certain instances) and the Secretary of Agriculture (in certain instances).

Finally, a waiver may be granted with respect to any building acquired from an insured depository institution in default (as defined in section 3 of the Federal Deposit Insurance Act) or from a receiver or conservator of such an institution

Explanation of Provision

The provision replaces the first two exceptions to the ten-year rule under present law with one new exception. The new exception waives the ten-year rule in the case of any Federally- or State-assisted building. For these purposes, the definition of Federally-assisted building is expanded to include any building which is substantially assisted, financed, or operated under

section 8 of the United States Housing Act of 1937, section 221(d)(3), 221(d)(4) or 236 of the National Housing Act, section 515 of the Housing Act of 1949, or any other housing program administered by the Depart of Housing and Urban Development or the Rural Housing Service of the Department of Agriculture. The term State-assisted building means any building which is substantially assisted, financed, or operated under any State law similar in purposes to those of the Federal laws used in the definition of a Federally-assisted building. The present-law exception related to certain depository institutions in default is retained.

Effective Date

The provision is effective for buildings placed in service after the date of enactment.

4. Other simplification and reform of low-income housing tax incentives (sec. 3004 of the bill and sec. 42 of the Code)

(a) Repeal prohibition of the credit for buildings receiving HUD moderate rehabilitation assistance

Present Law

Generally, the low-income housing credit is available to otherwise qualifying buildings which also receive direct assistance under HUD Section 8 programs. No credit is allowed to any building with respect to which moderate rehabilitation assistance is provided at any time during the compliance period, under section 8(e)(2) of the United States Housing Act of 1937 (other than assistance under the Stewart B. McKinney Homeless Assistance Act).

Explanation of Provision

The provision eliminates the present-law prohibition against providing the low-income housing credit to buildings receiving moderate rehabilitation assistance under section 8(e)(2) of the United States Housing Act of 1937.

Effective Date

The provision is effective for buildings placed in service after the date of enactment.

(b) Carryover allocation rule

Present Law

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 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.

Explanation of Provision

The provision modifies the first prong of the carryover allocation rule. Under this modification such an allocation will satisfy the first prong provided that 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 12 months after the allocation is made. The second prong of the carryover allocation rules is unchanged.

Effective Date

The provision is effective for buildings placed in service after the date of enactment.

(c) Repeal of bond posting requirement

Present Law

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 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.

Explanation of Provision

The provision eliminates the bond posting requirement. In its place the provision extends the otherwise applicable statute of limitation until three years after the Secretary of the Treasury is notified of noncompliance with the low-income housing credit rules.

Also, at the election of the taxpayer, the provision applies with respect to dispositions of interests in a building on or before the date of enactment if it is reasonably expected that such building will continue to be a qualified low-income building for the remaining compliance period.

Effective Date

The provision applies with respect to dispositions of interests in buildings after the date of enactment.

(d) Additions of energy efficiency and historic nature criteria to housing credit agency allocation plan criteria

Present Law

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.

Explanation of Provision

The provision adds two additional criteria which States must use in its allocation of credits among potential low-income housing projects. The additional criteria are: (1) the energy efficiency of the project; (2) the historic nature of the project (e.g., encouraging rehabilitation of certified historic structures (sec. 47(c)(3))).

Effective Date

The provision is effective for allocations made after December 31, 2008.

(e) Treatment of individuals who previously received foster care assistance

Present Law

In general, student housing does not qualify for the low-income housing credit. Two exceptions are provided from this general rule.[7] There two exceptions are units occupied by an individual: (1) who is a student and receiving assistance under title IV of the Social Security Act (Temporary Assistance for Needy Families); or (2) enrolled in a job training program receiving assistance under the Job Training Partnership Act or under other similar Federal, State, or local laws.

Explanation of Provision

The provision adds a third exception to the general rule that student housing is not eligible for the low-income housing credit. This new exception applies in the case of a student who was previously under the care and placement responsibility of a foster care program (under part B or E of title IV of the Social Security Act).

Effective Date

The provision is effective for determinations made after the date of enactment.

(f) Measurement of area median gross income for certain projects located in certain nonmetropolitan areas

Present Law

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 which 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").

In the case of property placed in service during 2006, 2007, and 2008 in a nonmetropolitan area within the Gulf Opportunity Zone, the income targeting rules of the low-income housing credit are applied by replacing the area median gross income standard with a national nonmetropolitan median gross income standard. These new income targeting rules apply to all such buildings in the Gulf Opportunity Zone regardless of whether the building receives its credit allocation under the otherwise applicable low-income housing credit cap or the additional credit cap (described above). The income targeting rules are not changed for buildings in metropolitan areas in the Gulf Opportunity Zone.

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[7] See also the discussion of the full-time student rule in item I.A.7., below.

Explanation of Provision

The measurement of area median gross income applied for residential rental property located in certain rural areas is modified in the case of projects subject to the low-income housing credit volume limits. In the case of such properties located in rural areas (as defined in section 520 of the Housing Act of 1949), the income targeting rules of the low-income housing credit are applied by reference to the greater of the otherwise applicable area median gross income standard, or the national nonmetropolitan median gross income. This new income targeting rule applies to all such buildings if the building receives a low-income housing credit allocation under the otherwise applicable low-income housing credit volume limit. It does not apply in the case of buildings which do not require a low-income housing credit allocation because they are substantially bond-financed. The area median gross income rules are not changed for buildings in metropolitan areas.

Effective Date

The provision is effective for determinations after the date of enactment.

(g) Clarification of general public use rule

Present Law

In order to be eligible for the low-income housing credit, the residential units in a qualified low-income housing project must be available for use by the general public. A project is available for general public use if: (1) the project complies with housing non-discrimination policies including those set forth in the Fair Housing Act (42. U.S.C. 3601), and (2) the project does not restrict occupancy based on membership in a social organization or employment by specific employers.[8] In addition, any residential unit that is part of a hospital, nursing home, sanitarium, lifecare facility, trailer park, or intermediate care facility for the mentally or physically handicapped is not available for use by the general public.

Explanation of Provision

The provision clarifies that a project which otherwise meets the general public use requirements above shall not fail to meet the general public use requirement solely because of occupancy restrictions or preferences that favor tenants: (1) with special needs; or (2) who are members of specified group under a Federal program or State program or policy that supports housing for such a specified group; or (3) who are involved in artistic and literary activities.

Effective Date

The provision applies to buildings placed in service before, on, or after the date of enactment.

[8] See Treas. Reg. 1.42-9.

(h) GAO study

Present Law

There are no current GAO studies planned of the low-income credit.

Explanation of Provision

The Comptroller General of the United States is directed to analyze the changes to the low-income credit made by this Act. The report shall be submitted to Congress not later than December 31, 2012.

Effective Date

The provision is effective on the date of enactment.

5. Treatment of Basic Housing Allowances for purposes of income eligibility rules (sec. 3005 of the bill and sec. 42 of the Code)

Present Law

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.

The military provides the basic housing allowance. The recipients of the military basic housing allowance must include these amounts for purposes of low-income credit eligibility.

Explanation of Provision

In general

Under the provision the basic housing allowance (i.e., payments under 37 U.S.C. sec. 403) is not included in income for the low-income credit income eligibility rule. The provision is limited in application to qualified buildings. A qualified building is defined as any building located:

1. any county which contains a qualified military installation to which the number of members of the Armed Forces assigned to units based out of such qualified military installation has increased by 20 percent or more as of June 1, 2008 over the personnel level on December 31, 2005; and

2. any counties adjacent to county described in (1), above.

For these purposes, a qualified military installation is any military installation or facility with at least 1000 members of the Armed Forces assigned to it.

Applicability

The provision applies to income determinations: (1) made after the date of enactment and before January 1, 2012 in the case of qualified buildings which received credit allocations on or before the date of enactment or qualified buildings placed in service on or before the date of enactment to the extent a credit allocation was not required with respect to such building by reason of 42(h)(4) (i.e. such qualified building was at least 50% tax bond financed with bonds subject to the private activity bonds volume cap) but only with respect to bonds issued before such date of enactment; and (2) made after the date of enactment in the case of qualified buildings which received credit allocations after the date of enactment and before January 1, 2012 or qualified buildings placed in service after the date of enactment and before January 1, 2012, to the extent a credit allocation was not required with respect to such qualified building by reason of 42(h)(4) (i.e. such qualified building was at least 50% tax bond financed with bonds subject to the private activity bond volume cap) but only with respect to bonds issued after such date of enactment and before January 1, 2012.

Effective Date

The proposal is effective for income determinations after the date of enactment.

6. Refunding treatment for certain multi-family housing bonds (sec. 3007 of the bill and sec. 146 of the Code)

Present Law

In general

Private activity bonds are bonds that nominally are issued by State or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such private person. 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, qualified mortgage bonds, qualified veterans' mortgage bonds, and 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." 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 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"). For calendar year 2008, the State volume cap, which is indexed for inflation, equals $85 per resident of the State, or $262.09 million, if greater.

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.[9]

Explanation of Provision

Under the provision, if within six months after receipt of a repayment of a conduit loan used to finance a qualified residential rental project, such repayment is used to finance a second qualified residential rental project, any bond issued to refinance the first issue of bonds (i.e., the bond financing the original conduit loan) shall be treated as a refunding issue. A loan to a person other than the governmental entity from the proceeds of a bond issue to carry out the defined qualified purpose of the issue is a conduit loan. Thus, under the provision, the refinancing bond is treated as a refunding notwithstanding a change in obligors under the first and second conduit loans. The provision only applies to the first refunding of the refunded bond and only if such refunding bond is issued within four years of the date of issue of the refunded bond. In addition, the final maturity date for the refunding bonds cannot be later than 34 years after the date of issuance of the refunded bond.

Effective Date

The provision applies to repayments of loans received after the date of enactment.

7. Coordination of certain rules applicable to the low-income housing credit and qualified residential rental project exempt facility bonds (sec. 3008 of the bill and sec. 142 of the Code)

(a) Next available unit rule

Present Law

In order to be eligible for the low-income housing credit, each of the residential units with respect to which the credit is claimed must be: (1) occupied by low-income tenants; and (2) rent-restricted. If the incomes of any such tenants rise above certain levels, then the credit with

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[9] Sec. 147(b).

respect to that unit is denied unless the next available unit in the low-income building (of a size comparable or smaller than such unit) is rented to a new tenant who satisfies the income and rent-restriction requirements (the "next-available-unit rule").[10]

Subject to certain requirements, tax-exempt bonds may be issued to finance qualified residential rental projects. The tax-exempt bond rules for qualified residential projects have similar tenant income limitations as the low-income credit, but apply the next available unit rule on a project basis rather than a building-by-building basis.[11] Therefore, to avoid noncompliance when the income of a tenant rises above certain levels, the next available unit (of a size comparable or smaller than such unit) in the entire project (rather than just the same building) must be rented to a new tenant who satisfies the income and rent-restriction requirements.

Explanation of Provision

In the case of a low-income building which is tax-exempt bond financed and eligible for the low-income housing credit, the provision provides that both the bond and credit restrictions will be satisfied if the next available unit in the building is rented to a new tenant who satisfies the income and rent-restriction requirements. It therefore conforms the tax-exempt bond rule to the low-income housing credit rule.

Effective Date

The provision applies to determinations of the status of qualified residential rental projects for periods beginning after the date of enactment with respect to bonds issued before, on, or after such date.

(b) Students

Present Law

In general

The low-income housing credit is not available for any residential unit unless it is available for use by the general public. For these purposes, a residential unit generally is available for use by the general public if the unit is rented in a manner consistent with housing policy governing nondiscrimination as evidenced by the rules and regulations of the Department of Housing and Urban Development ("HUD"). Notwithstanding compliance with the HUD rules and regulations, a residential rental unit is not available for use by the general public if such unit is: (1) provided only for a member of a social organization; or (2) provided by an employer for its employees. Other rules may apply.

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[10] Sec. 42(g)(2)(D)(ii).

[11] Sec. 142(d)(3)(B).

Rules for full-time students

For purposes of the low-income housing credit, no credit is allowed with respect to a otherwise eligible unit occupied entirely by full-time students: (1) unless those students are comprised entirely of single parents and their children; or (2) are married and file a joint return. . Further, the single parents may not be dependents of another individual and the children may not be dependents of another individual other than of their parents. For purposes of the tax-exempt bond rules, a slightly different full-time student rule applies. The tax-exempt bond rule provides that a residential unit will not satisfy the income tests if all the occupants are students (as defined in section 152(f)(2)) and are not entitled to file a joint tax return.

Explanation of Provision

The provision conforms the tax-exempt bond rule with respect to students to the low-income housing credit rule.

Effective Date

The full-time student provision applies to determinations of the status of qualified residential rental projects for periods beginning after the date of enactment with respect to bonds issued before, on, or after such date.

(c) Single-room occupancy units

Present Law

Unlike the requirements for projects financed with tax-exempt bonds, certain single-room occupancy housing used on a nontransient basis may qualify for the low-income 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.

Among other requirements, qualified residential rental projects financed with tax-exempt bonds generally cannot be used on a transient basis. Treasury regulations clarify that a residential unit will not be treated as used on a transient basis if the unit contains complete facilities for living, including living, sleeping, eating, cooking, and sanitation.[12]

Explanation of Provision

The provision conforms the tax-exempt bond rule to the low-income housing credit rule.

[12] Treas. Reg. sec. 1.103-8(b)(10)(ii).

Effective Date

The provision applies to determinations of the status of qualified residential rental projects for periods beginning after the date of enactment with respect to bonds issued before, on, or after such date.

8. Hold harmless for reductions in area median gross income (sec. 3009 of the bill and sec. 42 of the Code)

Present Law

Tax rules

Tax-exempt bonds

Residential rental property may be financed with exempt facility bonds if the financed project is a "qualified residential rental project." 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 (sec. 142).

Low-income housing tax credit

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 (sec. 42(g)). 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.

Determination of income and area median gross income

The income of individuals and area median gross income are determined by the Secretary of the Treasury in a manner consistent with determinations of lower-income families and area median gross income under section 8 of the Housing Act of 1937 (sec. 142(d)). These determinations under section 8 are made by HUD. These determinations also include adjustments for family size.

Therefore such determinations (individual and area median gross income) are applicable for purposes of tax-exempt bonds and the low-income housing credit.

HUD hold harmless policy

Generally HUD releases its calculation of area median gross income for a calendar year early in that year. Historically HUD has used the most recent decennial census data and updated it with other data on income, employment and earnings.

Recently HUD modified its methodology to include additional data in its calculation of area median gross income. In some instances this change in methodology resulted in significantly lower numbers for area median gross income in some areas. In response to this result, HUD provided that such areas are not treated as having a lower area median gross income for purposes of HUD housing programs.

Explanation of Provision

In general

The provision makes two modifications to the determination of area median gross income for purposes of tax-exempt bonds and the low-income housing credit.

Determination of income and area median gross income

The provision provides that any determination of area median gross income with respect to a project may not be less than the determination of area median gross income with respect to that project for the preceding calendar year. This modification applies to all projects and is not limited to projects benefiting from the HUD hold harmless policy.

HUD hold harmless policy

In the case of a HUD hold harmless impacted project, the determination of area median gross income for the project is the greater of (i) the amount determined without regard to the special rule for HUD hold harmless impacted projects or (ii) the sum of the area median gross income determined under the HUD hold harmless policy with respect to the project for 2008 plus any increase in area median gross income after 2008.

Effective Date

The provision applies to determinations of area median gross income for calendar years after 2008.

9. Exception from the annual recertification requirement for projects which are entirely low-income use (sec. 3010 of the bill and sec. 142 of the Code)

Present Law

Tax rules

In general

Tax-exempt bonds

Residential rental property may be financed with exempt facility bonds if the financed project is a "qualified residential rental project." 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 (sec. 142).

Low-income housing tax credits

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 (sec. 42(g)). 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.

Determination of income and area median gross income

The income of individuals and area median gross income are determined by the Secretary of the Treasury in a manner consistent with determinations of lower-income families and area median gross income under section 8 of the Housing Act of 1937 (sec. 142(d)). These determinations also include adjustments for family size.

Certification

The Code provides that the operator of any qualified residential rental project must submit to the Secretary of the Treasury (at such time and in such manner as the Secretary prescribes) an annual certification that the project continues to satisfy the requirements of a qualified residential rental project. Any failure to comply with the annual certification to the Secretary of the Treasury will subject the operator to penalties but will not affect the tax-exempt status of the underlying bonds (sec. 142(d)(7)).

Similar rules apply for the low-income housing credit regarding tenant incomes (sec. 42(g)(4)). IRS Revenue Procedure 1994-64 allows a taxpayer to request a waiver of this certification under certain circumstances with the consent of the State agency responsible for monitoring the low-income credit project.

Treatment of tenants whose incomes rise above the income limits

Generally a low-income unit will continue to be treated as such even when the tenant's income rises above the income limits provided that the next available unit (of a size comparable to or smaller than such unit) in the project is occupied by a new resident who satisfies the income limits.

HUD rules

A family's eligibility for various types of HUD housing assistance is based on its income and family composition. The HUD Handbook 4350.3 contains the certification and annual recertification rules to be followed by project operators. Under the HUD program requirements tenants have the responsibility to provide timely information to the project operators. Operators have the responsibility to review and verify the tenant information and to make changes to assistance payment and tenant rent to satisfy program requirements.

Explanation of Provision

The provision waives the annual recertification requirements under the low-income credit (sec. 42) and tax-exempt bonds (sec. 142) for any project as long as no residential unit in the project is occupied by tenants who fail to satisfy the otherwise applicable income limits. The provision does not modify the HUD rules; therefore some projects must continue annual certification notwithstanding this provision.

Effective Date

The provision is effective for years ending after the date of enactment.

B. Single Family Housing

1. First-time homebuyer credit (sec. 3011 of the bill and sec. 36 of the Code)

Present Law

Qualified mortgage bonds are issued to make mortgage loans to qualified mortgagors for owner-occupied residences. The subsidy provided for qualified mortgage bonds allows issuers to finance mortgages for homebuyers at reduced interest rates. The Code imposes several limitations on qualified mortgage bonds, including a "first-time homebuyer" requirement. The first-time homebuyer requirement provides that 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. In addition, bond proceeds generally only can be used for new mortgages, i.e., proceeds cannot be used to acquire or refinance existing mortgages.

In addition, prior to 2008, first-time homebuyers of a principal residence in the District of Columbia were eligible for a nonrefundable tax credit of up to $5,000 of the amount of the purchase price. The $5,000 maximum credit applies both to individuals and married couples filing a joint return. A married individual filing separately can claim a maximum credit of $2,500. The instructions to IRS Form 8859 (District of Columbia First-Time Homebuyer Credit) state that if "two or more unmarried individuals buy a main home, they can allocate the credit among the individual owners in any manner they choose." The credit phases out for individual taxpayers with modified adjusted gross income between $70,000 and $90,000 ($110,000-$130,000 for joint filers). For purposes of eligibility, "first-time homebuyer" means any individual if such individual did not have a present ownership interest in a principal residence in the District of Columbia in the one-year period ending on the date of the purchase of the residence to which the credit applies. The credit expired for residences purchased after December 31, 2007.[13]

Explanation of Provision

Under the proposal, a taxpayer who is a first-time homebuyer is allowed a refundable tax credit equal to the lesser of $7,500 ($3,750 for a married individual filing separately) or 10 percent of the purchase price of a principal residence. The credit is allowed for the tax year in which the taxpayer purchases the home.

The credit phases out for individual taxpayers with modified adjusted gross income between $75,000 and $95,000 ($150,000-$170,000 for joint filers) for the year of purchase.

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[13] Sec. 1400C. The credit was enacted as part of the Taxpayer Relief Act of 1997 and was originally scheduled to expire on December 31, 2000. It has been extended several times, the last extension through December 31, 2007.

A taxpayer is considered a first-time homebuyer if such individual had no ownership interest in a principal residence in the United States during the 3-year period prior to the purchase of the home to which the credit applies.

No credit is allowed if the D.C. homebuyer credit is allowable for the taxable year the residence is purchased or a prior taxable year. A taxpayer is not permitted to claim the credit if the taxpayer's financing is from tax-exempt mortgage revenue bonds, if the taxpayer is a nonresident alien, or if the taxpayer disposes of the residence (or it ceases to be a principal residence) before the close of a taxable year for which a credit otherwise would be allowable.

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. For example, if the taxpayer purchases a home in 2008, the credit is allowed on the 2008 tax return, and repayments commence with the 2010 tax return. If the taxpayer sells the home (or the home ceases to be used as the principal residence of the taxpayer or the taxpayer's spouse) prior to complete repayment of the credit, any remaining credit repayment amount is due on the tax return for the year in which the home is sold (or ceases to be used as the principal residence). However, the credit repayment amount may not exceed the amount of gain from the sale of the residence to an unrelated person. 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. No amount is recaptured after the death of a taxpayer. In the case of an involuntary conversion of the home, recapture is not accelerated if a new principal residence is acquired within a two year period. In the case of a transfer of the residence to a spouse or to a former spouse incident to divorce, the transferee spouse (and not the transferor spouse) will be responsible for any future recapture.

An election is provided to treat a home purchased in the eligible period in 2009 as if purchased on December 31, 2008 for purposes of claiming the credit on the 2008 tax return and for establishing the beginning of the recapture period. Taxpayers may amend their returns for this purpose.

Effective Date

The provision is effective for qualifying home purchases on or after April 9, 2008 and before July 1, 2009 (without regard to whether or not there was a binding contract to purchase prior to April 9, 2008).

2. Additional standard deduction for state and local real property taxes (sec. 3012 of the bill and sec. 63 of the Code)

Present Law

An individual taxpayer's taxable income is computed by reducing adjusted gross income either by a standard deduction or, if the taxpayer elects, by the taxpayer's itemized deductions. Unless an individual taxpayer elects, no itemized deduction is allowed for the taxable year. The

deduction for certain taxes, including income taxes, real property taxes, and personal property taxes, generally is an itemized deduction.[14]

Explanation of Provision

The provision increases an individual taxpayer's standard deduction for a taxable year beginning in 2008 by the lesser of (1) the amount allowable[15] to the taxpayer as a deduction for State and local taxes described in section 164(a)(1) (relating to real property taxes), or (2) $500 ($1,000 in the case of a married individual filing jointly). The increased standard deduction is determined by taking into account real estate taxes for which a deduction is allowable to the taxpayer under section 164 and, in the case of a tenant-stockholder in a cooperative housing corporation, real estate taxes for which a deduction is allowable to the taxpayer under section 216. No taxes deductible in computing adjusted gross income are taken into account in computing the increased standard deduction.

Effective Date

The provision applies to taxable years beginning in 2008.

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[14] If the deduction for State and local taxes is attributable to business or rental income, the deduction is allowed in computing adjusted gross income and therefore is not an itemized deduction.

[15] In the case of an individual taxpayer who does not elect to itemize deductions, although no itemized deductions are allowed to the taxpayer, itemized deductions are nevertheless treated as "allowable." See section 63(e).

C. General Provisions

1. Modifications to qualified private activity bond rules for housing (sec. 3021 of the bill and secs. 142, 143, and 146 of the Code)

Present Law

In general

Private activity bonds are bonds that nominally are issued by State or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such private person. 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, qualified mortgage bonds, qualified veterans' mortgage bonds, and bonds for qualified residential rental projects.

Qualified private activity bond rules for housing

Qualified mortgage bonds are issued to make mortgage loans to qualified mortgagors for owner-occupied residences. The Code imposes several limitations on qualified mortgage bonds, including income limitations for homebuyers, purchase price limitations for the home financed with bond proceeds, and a "first-time homebuyer" requirement. The income limitations are satisfied if all financing provided by an issue is provided for mortgagors whose family income does 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. The first-time homebuyer requirement provides that 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. In addition, bond proceeds generally only can be used for new mortgages, i.e., proceeds cannot be used to acquire or refinance existing mortgages. Under present law, the proceeds of qualified mortgage bonds generally must be used to finance mortgages within 42 months from the date of issuance of the bonds.

Residential rental property may be financed with qualified private activity bonds if the financed project is a "qualified residential rental project." 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").

As with most qualified private activity bonds, qualified mortgage bonds and bonds for qualified residential rental projects are subject to annual State volume limitations (the "State volume cap"). For calendar year 2008, the State volume cap, which is indexed for inflation, equals $85 per resident of the State, or $262.09 million, if greater. The interest income from

qualified mortgage bonds and bonds for qualified residential rental projects is a preference item for purposes of calculating the alternative minimum tax ("AMT").

Explanation of Provision

Temporary volume cap increase

The provision authorizes an additional $11 billion of volume cap for 2008 for the purpose of issuing qualified mortgage bonds or private activity bonds for qualified residential rental projects. The additional volume cap is allocated to each State in the same proportion as the total State volume is allocated to each of the States. Qualified mortgage bonds issued with respect to the additional volume cap may be used to finance either mortgages permitted under present law (e.g., new mortgages) or qualified subprime loans as defined under the bill. However, all proceeds of qualified mortgage bonds issued with respect to the additional volume cap must be used within 12 months of the date of issuance of such bonds. Additional volume cap that remains unused at the end of 2008 may be carried forward to 2009 and 2010, but solely for the purpose of issuing qualified mortgage bonds or private activity bonds for qualified residential rental projects.

Qualified mortgage bonds for certain refinancings

The provision creates an exception to the new mortgage requirement for qualified mortgage bonds by authorizing the use of such bonds to refinance a qualified subprime loan. The provision defines a qualified subprime loan as an adjustable rate residential mortgage loan originated after December 31, 2001, and before January 1, 2008, that the issuer determines would be reasonably likely to cause financial hardship to the borrower if not refinanced. Under the provision, proceeds of qualified mortgage bonds used to refinance qualified subprime loans must be so used within 12 months from the date of issuance of the bond. In addition, the provision also provides that qualified subprime loans cannot be refinanced by bonds issued after December 31, 2010.

Effective Date

The provision applies to bonds issued after the date of enactment.

2. Alternative minimum tax treatment of interest on certain bonds, the low-income housing credit, and the rehabilitation credit (sec. 3022 of the bill and secs. 38, 56 and 57 of the Code)

Present Law

In general

Present law imposes an alternative minimum tax ("AMT") on individuals and corporations. AMT is the amount by which the tentative minimum tax exceeds the regular income tax. The tentative minimum tax is computed based upon a taxpayer's alternative minimum taxable income ("AMTI"). AMTI is the taxpayer's taxable income modified to take into account certain preferences and adjustments.

Tax-exempt bonds

One of the preference items is tax-exempt interest on certain tax-exempt bonds issued for private activities (sec. 57(a)(5)). Also, in the case of a corporation, an adjustment based on current earnings is determined, in part, by taking into account 75 percent of items, including tax-exempt interest, that are excluded from taxable income but included in the corporation's earnings and profits (sec. 56(g)(4)(B)).

Low-income housing and rehabilitation credits

Business tax credits 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, business tax credits generally cannot offset the alternative minimum tax liability.[16]

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

Explanation of Provision

Tax-exempt bonds

The bill provides that tax-exempt interest on (i) exempt facility bonds issued as part of an issue 95 percent or more of the net proceeds of which are used to provide qualified residential rental projects (as defined in section 142(d)), (ii) qualified mortgage bonds (as defined in section 143(a)), and (iii) qualified veterans' mortgage bonds (as defined in section 143(b)) is not an item of tax preference for purposes of the alternative minimum tax. Also, this interest is not included in the corporate adjustment based on current earnings. The provision does not apply to interest on any refunding bond unless interest on the refunded bond (or in the case of a series of refundings, the original bond) was not an item of tax preference.

Low-income housing and rehabilitation credits

The bill treats the tentative minimum tax as being zero for purposes of determining the tax liability limitation with respect to the low-income housing credit and the rehabilitation credit.

Thus, the low-income housing tax credit and the rehabilitation credit may offset the alternative minimum tax liability.

[16] A special rule treats the tentative minimum tax as being zero for purposes of determining the tax liability limitation with respect to certain energy credits, the work opportunity credit and the credit for taxes paid with respect to employee cash tips (sec. 38(c)(4)). Thus, the credits listed in the preceding sentence may offset the alternative minimum tax liability.

Effective Date

The provision applies to interest on bonds issued after the date of enactment.

The provision applies to low-income housing credits determined under section 42 attributable to buildings placed in service after December 31, 2007 (including any carryback of the credits).

The provision applies to rehabilitation credits determined under section 47 attributable to qualified rehabilitation expenses properly taken into account for periods after December 31, 2007 (including any carryback of the credits).

3. Bonds guaranteed by Federal Home Loan Banks eligible for treatment as tax-exempt bonds (sec. 3023 of the bill and sec. 149 of the Code)

Present Law

Interest paid on bonds issued by State and local governments generally is excluded from gross income for Federal income tax purposes. However, the exclusion generally does not apply to State and local bonds that are Federally guaranteed. Under present law, a bond is Federally guaranteed if: (1) the payment of principal or interest with respect to such bond is guaranteed (in whole or in part) by the United States (or any agency or instrumentality thereof); (2) such bond is issued as part of an issue and five percent or more of the proceeds of such issue is to be (a) used in making loans the payment of principal or interest with respect to which is guaranteed (in whole or in part) by the United States (or any agency or instrumentality thereof), or (b) invested directly or indirectly in Federally insured deposits or accounts; or (3) the payment of principal or interest on such bond is otherwise indirectly guaranteed (in whole or in part) by the United States (or any agency or instrumentality thereof).

The Federal guarantee restriction was enacted in 1984 with certain exceptions for certain guarantee programs in existence at that time. The exceptions include guarantees by: the Federal Housing Administration; the Department of Veterans' Affairs; the Federal National Mortgage Association; the Federal Home Loan Mortgage Association; the Government National Mortgage Association; the Student Loan Marketing Association; and the Bonneville Power Authority. The exception also includes guarantees for certain housing programs. These are: (a) private activity bonds for a qualified residential rental project or a housing program obligation under section 11(b) of the United States Housing Act of 1937; (b) a qualified mortgage bond; or (c) a qualified veterans' mortgage bond.

Explanation of Provision

Under the provision, bonds issued by State and local governments are not treated as Federally guaranteed by reason of any guarantee provided by any Federal Home Loan Bank of a bond issued after the date of enactment and before January 1, 2011, if such bank made a guarantee of such bond in connection with such issuance.

The exception to the Federal guarantee prohibition does not apply to any guarantee by a Federal home loan bank unless such bank meets safety and soundness collateral requirements for

such guarantees which are at least as stringent as the regulatory requirements for guarantees by Federal home loan banks as in effect on April 9, 2008.

Effective Date

The provision applies to guarantees made after the date of enactment.

4. Modification of rules pertaining to FIRPTA nonforeign affidavits (sec. 3024 of the bill and sec. 1445 of the Code)

Present Law

In general, nonresident aliens and foreign corporations are not taxed on capital gains.[17] However, such foreign persons must take into account gains and losses from the disposition of an interest in United States real property ("USRPI"), as if such persons were engaged in a trade or business in the United States during the taxable year, and such gain or loss were effectively connected with such trade or business.[18]

Although tax is imposed upon such dispositions on a net basis, in the case of any disposition of a USRPI by a foreign person, the transferee is generally required to deduct and withhold a tax equal to ten percent of the amount realized.[19] The transferee is exempt from this withholding requirement if:

In general, the transferred interest is not a USRPI;

The transferee receives a "qualifying statement" from the Secretary of the Treasury (or his delegate) that states that the transferor is exempt from the tax on the disposition of the USRPI or has reached agreement with the Secretary for payment of such tax, and that any withholding tax has been satisfied or secured;

The USRPI is acquired by the transferee for use by him as a residence and the amount realized does not exceed $300,000; or

The transferor furnishes to the transferee an affidavit by the transferor stating, under penalties of perjury, the transferor's United States taxpayer identification number and that the transferor is not a foreign person. However, this rule does not apply if the transferee has actual knowledge that such affidavit is false or if the transferee receives a notice from a transferor's agent or a transferee's agent that such affidavit is false, or if the transferee fails to meet the Secretary's

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[17] Nonresident aliens present in the United States for a period or period aggregating 183 days or more during a taxable year are taxed at a flat 30 percent on their net U.S. source capital gains. Sec. 871(a)(2).

[18] Sec. 897(a)(1).

[19] Sec. 1445(a).

requirement that the transferee furnish a copy of such affidavit to the Secretary.[20] Regulations require the transferee to retain the transferor's affidavit until the end of the fifth taxable year following the taxable year in which the transfer takes place.[21]

In certain circumstances, agents may be liable for some or all of the withholding tax. In general, if the transferor's agent or the transferee's agent has actual knowledge that the affidavit is false, then such agent is required to notify the transferee pursuant to regulations.[22] An agent that is required to notify the transferee pursuant to regulations yet fails to do so is under the same duty to deduct and withhold that the transferee would have been under if such agent had properly given such notice.[23] However, an agent's liability under these circumstances is limited to the amount of the agent's compensation from the transaction.[24]

In the case of a real estate transaction, a "real estate reporting person" is required to file an information return and to furnish certain written statements to customers.[25] A real estate reporting person means the person (including any attorney or title company) responsible for closing the transaction, if there is such a person.[26]

Explanation of Provision

The provision provides an alternate procedure with respect to the nonforeign affidavit. Under this procedure, in lieu of furnishing a nonforeign affidavit to the transferee, a transferor may furnish such affidavit to a "qualified substitute." Such qualified substitute is then required to furnish a statement to the transferee stating, under penalties of perjury, that the qualified substitute has such affidavit in his or her possession. With respect to a disposition of a USRPI, the term "qualified substitute" means (1) the person, including any attorney or title company, responsible for closing the transaction, other than the transferor's agent, and (2) the transferee's agent.

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[20] Sec. 1445(b).

[21] Treas. Reg. sec. 1.1445-2(b)(3).

[22] Sec. 1445(d)(1).

[23] Sec. 1445(d)(2)(A).

[24] Sec. 1445(d)(2)(B).

[25] Sec. 6045(e)(1). There is an exception to this requirement for a sale or exchange of a residence for $250,000 or less ($500,000 if the seller is married), if certain conditions are met. Sec. 6045(e)(5).

[26] If there is no such person, then the real estate reporting person with respect to that transaction is either the mortgage lender, seller's broker, buyer's broker, or other person designated under regulations, in that order. Sec. 6045(e)(2).

This exemption does not apply if the transferee or qualified substitute has actual knowledge that such affidavit or statement is false, if the transferee or qualified substitute receives a notice from a transferor's agent, transferee's agent, or qualified substitute that such affidavit or statement is false, or if the transferee or qualified substitute fails to meet a regulatory requirement that the transferee or qualified substitute furnish a copy of such affidavit or statement to the Secretary.

Moreover, if the transferor's agent, the transferee's agent, or the qualified substitute has actual knowledge that the affidavit or statement is false, then such agent or qualified substitute is required to notify the transferee. As under present law, the time and manner of such notice is to be specified by regulations. An agent or qualified substitute that is required to notify the transferee pursuant to regulations yet fails to do so has the same duty to deduct and withhold that the transferee would have had if such agent or qualified substitute had properly given such notice. An agent's or qualified substitute's liability under these circumstances is limited to the amount of the compensation that such agent or qualified substitute derives from the transaction.

The Secretary of the Treasury is required to prescribe such regulations as may be necessary or appropriate to carry out this provision. It is intended that such rules will require the qualified substitute and transferee to retain the documentation for a period commensurate with the period required under the present-law regulations.

Effective Date

The provision is effective for dispositions after the date of enactment.

5. Modify rehabilitation credit tax-exempt use safe harbor and definition of disqualified lease (sec. 3025 of the House bill and sec. 47 of the Code)

Present Law

A 10-percent credit is provided for rehabilitation expenditures with respect to buildings first placed in service before 1936. A 20-percent credit is provided for rehabilitation expenditures with respect to a certified historic structure.

Rehabilitation expenditures eligible for the credit do not include any expenditure in connection with the rehabilitation of a building that is allocable to the portion of the property that is (or may reasonably be expected to be) tax-exempt use property. In the case of nonresidential real property, tax-exempt use property generally means the portion of the property leased in a disqualified lease to tax-exempt entities (sec. 168(h)(1)). For this purpose, a tax-exempt entity means (1) the United States, a State or political subdivision, a U.S. possession, or an agency or instrumentality thereof, (2) a tax-exempt organization, (3) a foreign person or entity, or (4) an Indian tribal government.

A safe harbor provides, however, that in the case of nonresidential real property, the property is treated as tax-exempt use property only if the portion of the property leased to tax-exempt entities in disqualified leases is more than 35 percent of the property.

A disqualified lease for this purpose is a lease to a tax-exempt entity in specified circumstances. These are: (1) part or all of the property was financed, directly or indirectly, by tax-exempt bond financing and the entity (or a related entity) participated in the financing; (2) under the lease there is a fixed or determinable price purchase or sale involving the entity or a related entity (or the equivalent of such an option); (3) the term of the lease exceeds 20 years; or (4) there has been a sale and leaseback of the property and the entity (or a related entity) used the property before the sale, transfer, or lease (sec. 168(h)(1)(B)).

Explanation of Provision

The provision increases from 35 percent to 50 percent the percentage of the property that may be leased to a tax-exempt entity in a disqualified lease without requiring allocation of rehabilitation expenditures under the rehabilitation credit. Under the provision, for determining rehabilitation expenditures eligible for the credit, nonresidential real property is treated as "tax-exempt use" property only if the portion of the property leased to tax-exempt entities in disqualified leases is more than 50 percent of the property. For this purpose, a tax-exempt entity continues to have the same meaning provided by present law.

Effective Date

The provision is effective for expenditures properly taken into account for periods after December 31, 2007.

6. Special rules for mortgage revenue bonds in Presidentially declared disaster areas (sec. 3026 of the bill and sec. 143 of the Code)

Present Law

In general

Under present law, gross income does not include interest on State or local bonds (sec. 103). 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 which 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 does not apply to private activity bonds, unless the bonds are issued for certain permitted purposes ("qualified private activity bonds") (secs. 103(b)(1) and 141).

Qualified mortgage bonds

The definition of a qualified private activity bond includes a qualified mortgage bond (sec. 143). Qualified mortgage bonds are issued to make mortgage loans to qualified mortgagors for the purchase, improvement, or rehabilitation of owner-occupied residences. The Code imposes several limitations on qualified mortgage bonds, including income limitations for homebuyers and purchase price limitations for the home financed with bond proceeds. 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 first-time homebuyer requirement does not apply to 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 an income which is 80 percent or less of the state-wide median income or (2) an area of chronic economic distress.

A temporary provision waived the first-time homebuyer requirement for residences located in certain Presidentially declared disaster areas (sec. 143(k)(11)). In addition, residences located in such areas were treated as targeted area residences for purposes of the income and purchase price limitations. The special rule for residences located in Presidentially declared disaster areas does not apply to bonds issued after December 31, 1998.

Explanation of Provision

The provision waives the first-time homebuyer requirement for residences located in Presidentially declared disaster areas. In addition, residences located in such areas were treated as targeted area residences for purposes of the income and purchase price limitations. The provision applies to bonds issued after May 1, 2008 and before January 1, 2010.

Effective Date

The provision is effective on the date of enactment.

7. Transfer of funds appropriated to carry out 2008 recovery rebates to individuals (sec. 3027 of the bill)

Present Law

The Economic Stimulus Act of 2008 (Pub. L. No. 110-185) appropriated the following sums, for the fiscal year ending September 30, 2008 to the Department of the Treasury: (1) an additional amount for the Financial Management Service--Salaries and Expenses", $64,175,000, to remain available until September 30, 2009; (2) an additional amount for the Internal Revenue Service--Taxpayer Services", $50,720,000, to remain available until September 30, 2009; and (3) an additional amount for Internal Revenue Service--Operations Support", $151,415,000, to remain available until September 30, 2009. The Economic Stimulus Act also appropriated an additional amount for the ``Social Security Administration--Limitation on Administrative Expenses", $31,000,000, to remain available until September 30, 2008.

Explanation of Provision

The bill provides that the Secretary of the Treasury may transfer funds among the three accounts specified for the Department of Treasury to carry out the purposes of the Economic Stimulus Act.

Effective Date

The provision is effective on the date of enactment.

TITLE II – REFORMS RELATED TO REAL ESTATE INVESTMENT TRUSTS ("REITS") (secs. 3031-3071 of the bill and secs. 856 and 857 of the Code)

Present Law

In general

A real estate investment trust ("REIT") is an entity that otherwise would be taxed as a U.S. corporation but elects to be taxed under a special REIT tax regime. In order to qualify as a REIT, an entity must meet a number of requirements. At least 90 percent of REIT income (other than net capital gain) must be distributed annually;[27] the REIT must derive most of its income from passive, generally real-estate-related investments; and REIT assets must be primarily real-estate related. In addition, a REIT must have transferable interests and at least 100 shareholders, and no more than 50 percent of the REIT interests may be owned by 5 or fewer individual shareholders (as determined using specified attribution rules). Other requirements also apply.[28]

If an electing entity meets the requirements for REIT status, the portion of its income that is distributed to its shareholders each year as a dividend is deductible by the REIT (unlike the case of a regular subchapter C corporation, which cannot deduct dividends). As a result, the distributed income of the REIT is not taxed at the entity level; instead, it is taxed only at the investor level.[29]

Income tests

In general

A REIT is restricted to earning certain types of generally passive income. Among other requirements, at least 75 percent of the gross income of a REIT in each taxable year must consist of real-estate-related income. Such income includes: rents from real property; income from the sale or exchange of real property (including interests in real property) that is not stock in trade, inventory, or held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business; interest on mortgages secured by real property or interests in real property; and certain income from foreclosure property (the "75-percent income test").[30] Amounts attributable

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[27] Even if a REIT meets the 90 percent income distribution requirement for REIT qualification, more stringent distribution requirements must be met in order to avoid an excise tax under section 4981.

[28] Secs. 856 and 857.

[29] A REIT that has net capital gain can either distribute that gain as a "capital gain" dividend or retain that gain without distributing it but cause the shareholders to be treated as if they had received and reinvested a capital gain dividend. In either case, the gain in effect is taxed only as net capital gain of the shareholders. Sec. 857(b)(3).

[30] Secs. 856(c)(3) and 1221(a)(1). Income from sales that are not prohibited transactions solely by virtue of section 857(b)(6) also is qualified REIT income.

to most types of services provided to tenants (other than certain "customary services"), or to more than specified amounts of personal property, are not qualifying rents.[31] In addition, rents received from any entity in which the REIT owns more than 10 percent of the vote or value also generally are not qualifying income. However, there is an exception for certain rents received from taxable REIT subsidiaries (described further below), in which a REIT may own more than 10 percent of the vote or value.

In addition, 95 percent of the gross income of a REIT for each taxable year must be from the 75-percent income sources and a second permitted category of other, generally passive investments such as dividends, capital gains, and interest income (the "95-percent income test").[32]

Income from certain hedging transactions

Except as provided by Treasury regulations, income from a hedging transaction that is clearly identified,[33] including gain from the sale or disposition of such a transaction, is not included as gross income under the 95-percent income test, to the extent the transaction hedges any indebtedness incurred or to be incurred by the REIT to acquire or carry real estate assets.[34]

Foreign currency exchange gain

A REIT must be a U.S. domestic entity, but it is permitted to hold foreign real estate or other foreign-based assets, provided the 75-percent and 95-percent income tests and the other requirements for REIT qualification are met.[35] A REIT that holds foreign real estate or other foreign-based assets may have foreign currency exchange gain under the foreign currency transaction rules of the Code (described below). Foreign currency exchange gain is not explicitly included in the statutory definitions of qualifying income for purposes of the 75-percent and 95-percent income tests, though the IRS has issued guidance that allows foreign currency gain to be treated as qualified income in certain circumstances.

The foreign currency transaction rules of sections 985 through 989 apply whenever a taxpayer engages in a business or investment activity using a currency other than the taxpayer's functional currency (a "nonfunctional currency"). Section 985 provides in general that all determinations for Federal income tax purposes are made in the taxpayer's functional currency.

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[31] Sec. 856(d). Amounts attributable to the provision of certain services by an independent contractor or by a taxable REIT subsidiary can be qualified rents. Sec. 856(d)(7).

[32] Sec. 856(c)(3).

[33] A hedging transaction for this purpose is one defined in clause (ii) or (iii) of section 1221(b)(2)(A). The identification requirement is defined in section 1221(a)(7).

[34] Sec. 856(c)(5)(G).

[35] *See* Rev. Rul. 74-191, 1974-1 C.B. 170.

A taxpayer's functional currency is the dollar except in the case of a qualified business unit ("QBU"), in which case the functional currency is "the currency of the economic environment in which a significant part of such unit's activities are conducted and which is used by such unit in keeping its books and records."[36] A QBU is any separate and clearly identified unit of a trade or business of a taxpayer if the unit maintains separate books and records.[37]

A taxpayer that engages in a business or investment activity using a currency other than the U.S. dollar may have gain or loss under section 987 or 988, depending on the nature of the activity and type of entity (if any) through which the activity is conducted.

A U.S. taxpayer becomes subject to section 988 when it enters into a "section 988 transaction." Among other things, a "section 988 transaction" includes the acquisition of a debt instrument, becoming an obligor under a debt instrument, the accrual of items of expense or gross income, or the disposition of any nonfunctional currency.[38]

When a REIT holds a mortgage (or other instrument or arrangement described in section 988)[39] denominated in a nonfunctional currency or determined by reference to the value of a nonfunctional currency and the applicable foreign currency exchange rate changes between the time interest on an obligation to (or an obligation of) the REIT accrues and the time it is paid, the REIT may have foreign currency gain or loss under the rules of section 988. Foreign currency exchange gain under section 988 also can result when a REIT receives payment of principal on a debt instrument denominated in a nonfunctional currency or sells such a debt instrument, or when a REIT incurs a debt obligation denominated in a nonfunctional currency and pays interest or principal in that currency.

In May 2007, the IRS ruled in Rev. Rul. 2007-33 that if section 988 currency gain is recognized by a REIT with respect to an item of income, the section 988 gain will be qualifying income for purposes of the 95-percent and 75-percent income tests of section 856(c)(2) and (3),

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[36] Sec. 985(b)(1).

[37] Sec. 989(a).

[38] Sec. 988(c)(1)(B) and (C).

[39] Section 988 applies to (i) the acquisition of a debt instrument or becoming the obligor under a debt instrument; (ii) accruing (or otherwise taking into account) any item of expense or gross income or receipts which is to be paid after the date on which so accrued or taken into account, and (iii) entering into or acquiring any forward contract, futures contract, option, or similar financial instrument (except for any regulated futures contract or nonequity option which would be marked to market under section 1256 if held on the last day of the taxable year). Section 988 also applies to the disposition of any nonfunctional currency. Nonfunctional currency includes "coin or currency, and nonfunctional currency denominated demand or time deposits or similar instruments issued by a bank or other financial institution." Sec. 988(c)(1).

respectively, to the extent the underlying income so qualifies. Analogous relief was not provided for section 988 gain with respect to any items other than income items.[40]

Section 987 applies when there is a remittance from a foreign business or investment activity conducted through a QBU that is a branch that keeps its books and records in a functional currency other than the dollar. If a REIT has a QBU that keeps its books and records in a foreign currency, the REIT could have foreign currency exchange gain or loss under section 987 with respect to remittances.[41]

The IRS has ruled in several private rulings that a REIT may establish a REIT subsidiary that itself qualifies as a separate REIT (and thus would not be treated as a branch) to conduct qualified REIT activity with respect to foreign investments in a particular foreign currency, and that subsidiary can itself be treated as a QBU whose functional currency is that particular foreign currency, if that subsidiary keeps its books and records in that particular foreign currency.[42] This structure provides a method for a REIT to conduct activities abroad and minimize any concerns regarding the treatment of foreign currency gain for purposes of the 75-percent and 95-percent income tests. However, this structure effectively requires a separate REIT subsidiary that itself qualifies as a REIT, for each different currency in which the REIT may conduct activities.[43]

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[40] Rev. Rul. 2007-33, 2007-1 C.B. 1281. This ruling does not address the treatment of currency gain that might arise with respect to the payment of principal on an obligation that would produce qualified income. The ruling also does not address the treatment of foreign currency gain that might arise in connection with indebtedness denominated in a foreign currency that is incurred to acquire assets that produce qualifying income. A private letter ruling concluded that section 988 currency gain attributable to fluctuation in the exchange rates of currency used to make payments on non-dollar debt obligations incurred to acquire investments that produced qualifying non-dollar income would be treated as qualifying income, where the borrowings were to be used to finance the acquisition of the investments on a cost-effective basis, and not to speculate in foreign currency. PLR 200808024. A private letter ruling may be relied upon only by the taxpayer to which the ruling is issued.

[41] Recent proposed regulations under section 987 would replace previously proposed rules in an attempt to limit the ability of taxpayers to recognize non-economic foreign currency losses that could reduce otherwise taxable income, as well as to prevent non-economic currency gains that could arise. The 2006 proposed regulations would provide certain tracing-type rules. See REG-208270-86 (Sept. 7, 2006). See also, Notice 2000-20 (March 22, 2000), discussing concerns regarding earlier proposed regulations issued in 1991. The 2006 proposed regulations when originally issued did not by their terms apply to REITs, RICs, or certain other types of entities. Prop. Reg. Sec. 1.987-1(b)(iii). But see Notice 2007-42, 2007-1 C.B. 1288, *infra*.

[42] *See, e.g.,* PLR 200625019 and PLR 200550025. A private letter ruling may be relied upon only by the taxpayer to which the ruling was issued.

[43] In this structure, the parent REIT treats the dividends paid by the subsidiary REIT as a qualified REIT dividend, minimizing any currency gains by exchanging the foreign currency into dollars at the time of the dividend distribution.

At the same time that it issued Rev. Rul. 2007-33, the IRS also issued a notice regarding the application of section 987 to a QBU of a REIT. The notice states that until further guidance is issued, a REIT that has a QBU that uses a functional currency other than the U.S. dollar may apply the principles of proposed regulations issued on September 7, 2006, to determine whether section 987 currency gain is derived from income described in sections 856(c)(2) or (3).[44]

Certain other items

Certain private letter rulings issued to particular taxpayers have permitted various other types of income to be ignored for purposes of the 75-percent or 95-percent income tests, due to the relationship of the income to REIT qualifying assets or income. A few examples include a settlement payment received by a REIT with respect to construction of a mall or a payment received as a "breakup" fee in a proposed merger.[45]

Asset tests

At least 75 percent of the value of a REIT's assets must be real estate assets, cash and cash items (including receivables), and Government securities (the "75-percent asset test"). Real estate assets are real property (including interests in real property and mortgages on real property) and shares (or transferable certificates of beneficial interest) in other REITs.[46] No more than 25 percent of a REIT's assets may be securities other than such real estate assets.[47]

Except with respect to a taxable REIT subsidiary (described further below), not more than 5 percent of the value of a REIT's assets may be securities of any one issuer, and the REIT may not possess securities representing more than 10 percent of the outstanding value or voting power of any one issuer.[48] In addition, (except in the case of certain timber REITs for a limited time period), not more than 20 percent of the value of a REIT's assets may be securities of one or more taxable REIT subsidiaries.[49]

[44] Notice 2007-42, 2007-1 C.B. 1288. Compare REG-208270-86 (Sept. 7, 2006), which by its terms did not apply to REITs.

[45] PLR 200039027 and PLR 200127024. A private letter ruling may relied upon only by the taxpayer to which the ruling was issued.

[46] Sec. 856(c)(4)(A). Temporary investments in certain stock or debt instruments also can qualify if they are temporary investments of new capital, but only for the one-year period beginning on the date the REIT receives such capital. Sec. 856(c)(5)(B).

[47] Sec. 856(c)(4)(B)(i).

[48] Sec. 856(c)(4)(B)(iii).

[49] Sec. 856(c)(4)(B)(ii). In the case of a "timber REIT" defined as a REIT more than 50 percent of the value of whose assets consists of real property held in connection with the trade or business or producing timber, up to 25 percent of the value of the REITs assets may be securities of one or more taxable REIT subsidiaries. This special rule is in place only for taxable years beginning after the date of

The asset tests must be met as of the close of each quarter of a REIT's taxable year. However, a REIT that has met the asset tests as of the close of any quarter does not lose its REIT status solely because of a discrepancy during a subsequent quarter between the value of the REIT's investments and such requirements, unless such discrepancy exists immediately after the acquisition of any security or other property and is wholly or partly the result of such acquisition.[50]

Taxable REIT subsidiaries

A REIT generally cannot own more than 10 percent of the vote or value of a single entity; however, there is an exception for ownership of a taxable REIT subsidiary ("TRS") that is taxed as a corporation, provided that securities of one or more TRSs do not represent more than 20 percent[51] of the value of REIT assets.

A TRS generally can engage in any kind of business activity except that it is not permitted directly or indirectly to operate either a lodging facility or a health care facility. However, a TRS is permitted to rent hotel, motel, or other transient lodging facilities from its parent REIT and is permitted to hire an independent contractor to operate such facilities.[52]

Furthermore, rent paid to the parent REIT by the TRS with respect to hotel, motel, or other transient lodging facilities operated by an independent contractor is qualified rent for purposes of the REIT's 75-percent and 95-percent income tests. This lodging facility rental rule is an exception to the general rule that rent paid to a REIT by any corporation (including a TRS) in which the REIT owns 10 percent or more of the vote or value is not qualified rental income for purposes of the 75-percent or 95-percent REIT income tests. An exception to the general rule exists in the case of a TRS that rents space in a building owned by its parent REIT if at least 90 percent of the space in the building is rented to unrelated parties and the rent paid by the TRS to the REIT is comparable to the rent paid by the unrelated parties.[53]

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enactment of the Food, Conservation, and Energy Act of 2008 (H.R. 2419, P.L. No. 110-234, enacted on May 22, 2008) and before the date that is one year after such date of enactment.

[50] Sec. 856(c)(4). In the case of such an acquisition, the REIT also has a grace period of 30 days after the close of the quarter to eliminate the discrepancy.

[51] 25 percent for certain timber REITs for a one-year period. See "Asset tests," *supra*.

[52] An independent contractor will not fail to be treated as such for this purpose because the TRS bears the expenses of operation of the facility under the contract, or because the TRS receives the revenues from the operation of the facility, net of expenses for such operation and fees payable to the operator pursuant to the contract, or both. Sec. 856(d)(9)(B).

[53] REITs are also subject to a tax equal to 100 percent of redetermined rents, redetermined deductions, and excess interest. These are defined generally as the amounts of specified REIT transactions with a TRS of the REIT, to the extent such amounts differ from an arm's length amount.

Prohibited transactions tax

REITs are subject to a prohibited transaction tax ("PTT") of 100 percent of the net income derived from prohibited transactions. For this purpose, a prohibited transaction is a sale or other disposition of property by the REIT that is "stock in trade of a taxpayer or other property which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held for sale to customers by the taxpayer in the ordinary course of his trade or business" (sec. 1221(a)(1))[54] and is not foreclosure property. The PTT for a REIT does not apply to a sale if the REIT satisfies certain safe harbor requirements in sections 857(b)(6)(C) or (D), including an asset holding period of at least four years (2 years in the case of certain sales of timber property for a limited time period).[55] If the conditions are met, a REIT may either i) make no more than 7 sales within a taxable year (other than sales of foreclosure property or involuntary conversions under section 1033), or ii) sell no more than 10 percent of the aggregate bases of all its assets as of the beginning of the taxable year (computed without regard to sales of foreclosure property or involuntary conversions under section 1033), without being subject to the PTT tax.

Explanation of Provision

Foreign currency gain

Exclusion of certain foreign currency gain for certain income tests

The provision excludes certain foreign currency gain recognized under section 987 or section 988 from the computation of qualifying income for purposes of the 75-percent income test or the 95-percent income test, respectively.[56] The exclusion is solely for purposes of the computations under these tests.

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[54] This definition is the same as the definition of certain property the sale or other disposition of which would produce ordinary income rather than capital gain under section 1221(a)(1).

[55] Additional requirements for the safe harbor limit the amount of expenditures the REIT can make during the four year period prior to the sale that are includible in the adjusted basis of the property, require marketing to be done by an independent contractor, and forbid a sales price that is based on the income or profits of any person. Under the Food, Conservation, and Energy Act of 2008 (H.R. 2419, P.L. No. 110-234, enacted on May 22, 2008), the four-year holding period is reduced to two years in the case of a sale of timber property under section 857(b)(1)(D), provided the sale is to a qualified organization (as defined in section 170(h)(3)), exclusively for conservation purposes (as defined in section 170(h)(1)(C). The rule is in place only for taxable years beginning after the date of enactment of that Act and before one year following such date of enactment. In addition, for the same one year period, any sale that is exempt from the prohibited transactions provision by virtue of section 857(b)(1)(D) is treated for all purposes of subtitle A of the Code as a sale of property held for investment or use in a trade or business, and not property described in section 1221(a)(1) of the Code.

[56] The excluded amounts are excluded from both the numerator and the denominator in the relevant computations.

The provision defines two new categories of income for purposes of the exclusion rules: "real estate foreign exchange gain" and "passive foreign exchange gain." Real estate foreign exchange gain is excluded from gross income for purposes of both the 75-percent and 95-percent income tests. Passive foreign exchange gain is excluded for purposes of the 95-percent income test but is included in gross income and treated as non-qualifying income to the extent that it is not real estate foreign exchange gain, for purposes of the 75-percent income test.

Real estate foreign exchange gain is foreign currency gain (as defined in section 988(b)(1)) which is attributable to (i) any item of income or gain described in section 856(c)(3) (i.e., described in the 75-percent income test), (ii) the acquisition or ownership of obligations secured by mortgages on real property or interests in real property; or (iii) becoming or being the obligor under obligations secured by mortgages on real property or on interests in real property. Real estate foreign exchange gain also includes section 987 gain attributable to a qualified business unit ("QBU") of the REIT if the QBU itself meets the 75-percent income test for the taxable year, and meets the 75-percent asset test at the close of each quarter of the REIT that has directly or indirectly held the QBU. The QBU is not required to meet the 95-percent income test in order for this 987 gain exclusion to apply. Real estate foreign exchange gain also includes any other foreign currency gain as determined by the Secretary of the Treasury.

Passive foreign exchange gain includes all real estate foreign exchange gain, and in addition includes foreign currency gain which is attributable to (i) any item of income or gain described in section 856(c)(2) (i.e., described in the 95-percent income test), (ii) the acquisition or ownership of obligations, (iii) becoming or being the obligor under obligations, and (iv) any other foreign currency gain as determined by the Secretary of the Treasury.

Notwithstanding the foregoing rules, except in the case of certain income that is excluded under the hedging rules of section 856(c)(5)(G) (as amended by the provision), any section 988 gain derived from engaging in dealing, or substantial and regular trading, in securities (as defined in section 475(c)(2)) shall constitute gross income that does not qualify under either the 75-percent or 95-percent income test.

The effect of these rules is to change the result of Rev. Rul. 2007-33 in the case of foreign currency gain attributable to an item of REIT income that qualifies under sections 856(c)(2) or 856(c)(3), respectively, because the provision excludes such gain (solely for purposes of the relevant income test) rather than treating such gain as qualified income for purposes of that test. The provision in addition excludes foreign currency gain attributable to principal payments received on certain REIT assets, or to principal or interest payments with respect to certain liabilities of a REIT, situations not addressed in the revenue ruling.

The rules of the provision also supersede Notice 2007-42 in the case of remittances from a QBU that uses a functional currency other than the dollar. The provision excludes section 987 gain on a remittance from such a QBU to the REIT from the computation of both the 75-percent and the 95-percent income tests of the REIT, provided the QBU itself both meets the 75-percent income test for the taxable year and meets the 75-percent asset test at the close of each quarter of the taxable year. If the QBU meets these requirements, the 987 gain is excluded entirely for purposes of the REIT gross income tests, and no tracing-type rules with respect to 987 gain are imposed, as would have been the case under Notice 2007-42. For this purpose, the QBU is

tested as if it were a separate entity that is independently required to meet the 75-percent income test and the 75-percent asset test applicable to REIT qualification. However, the QBU need not meet any of the other REIT requirements, nor itself be treated as a REIT. It is expected that the Treasury Department will use its regulatory authority[57] to provide appropriate rules with respect to the treatment of section 987 currency gain for purposes of the REIT gross income tests if a QBU does not meet the requirements of the provision.

In the case of a section 988 transaction, it is intended that the provision only apply to foreign currency gain that is directly attributable to income items that otherwise are treated as qualifying income for purposes of the 75-percent and 95-percent income tests, respectively, (or directly attributable to the acquisition or ownership of, or to becoming the obligor under, obligations secured by mortgages on real property or on interests on real property). As one example, foreign currency gain attributable to exchange rate fluctuations between the time of the accrual of interest income on a foreign-currency denominated obligation secured by a mortgage on real property and the time of payment, would constitute excluded income for purposes of both the 75-percent and 95-percent income tests. However, any additional foreign currency gain arising from subsequent disposition of the foreign currency received upon payment of the accrued interest would be attributable to holding the foreign currency after its receipt and would not constitute excluded income under either test; rather it would be non-qualifying income.

Similarly, in the case of section 987 foreign currency gain on remittances, only section 987 gain as of the time of, and resulting from, the remittance is attributable to the QBU and is excluded income. Any currency gain arising from holding currency after remittance is not attributable to the QBU. Such gain is not excluded income for purposes of the 75-percent or 95-percent income tests and is not qualifying income for purposes of those tests.

The following examples demonstrate the operation of the distinction between "real estate foreign exchange gain", which is excluded for purposes of both the 75-percent and 95-percent income tests, and "passive foreign exchange gain," which is excluded only for purposes of the 95-percent income test and which is non-qualifying income for purposes of the 75-percent income test.

Example 1.–Assume that a REIT whose functional currency is the dollar holds an obligation that is secured by a mortgage on real property, which instrument pays interest at a date later than the date the interest is accrued by the REIT. The obligation is denominated in a foreign currency. Under sections 856(c)(3) and 856(c)(2), the REIT's interest income accrued on such a mortgage obligation is qualified income for purposes of the 75-percent and 95-percent income tests. Under the provision, any section 988 gain attributable to currency fluctuations between the time the interest is accrued by the REIT and the time the interest is paid to the REIT is real estate foreign exchange gain because it is directly attributable to the qualified interest income, and thus the section 988 gain is excluded for purposes of the 75-percent and 95-percent income tests.

[57] *See, e.g.* Sec. 989(c).

Example 2.–Assume the same facts as in Example 1, except that the instrument held by the REIT is a debt instrument that is not an obligation secured by a mortgage on real property or an interest in real property. Under sections 856(c)(3) and 856(c)(2), interest income accrued by the REIT is qualified income for purposes of the 95-percent income test but is not qualified income for purposes of the 75-percent income test. Under the provision, any section 988 gain attributable to currency fluctuations between the time the interest is accrued and the time the interest is paid is passive foreign exchange gain because it is directly attributable to the interest income that is qualified for purposes of the 95-percent income test. Such passive foreign exchange gain is excluded for purposes of the 95-percent income test but is not excluded (and is not qualified income) for purposes of the 75-percent income test.

Example 3.–Assume the same facts as in Example 1, and further assume that the REIT receives a repayment of the principal on the obligation. Under the provision, any section 988 gain attributable to the receipt of principal is real estate foreign exchange gain because it is attributable to the acquisition or ownership of an obligation secured by a mortgage on real property. Such section 988 gain is excluded for purposes of both the 75-percent and 95-percent income tests.

Example 4.–Assume the same facts as in Example 2, and further assume that the REIT receives a repayment of the principal on the obligation. Under the provision, any section 988 gain attributable to the receipt of principal is passive foreign exchange gain because it is attributable to the acquisition or ownership of an obligation not secured by a mortgage on real property or an interest in real property. Such section 988 gain is excluded for purposes of the 95-percent income test but is not excluded, and is not qualified income, for purposes of the 75-percent income test.

Other rules

The provision makes several changes to other REIT provisions.

First, the provision extends the present law rule of section 856(c)(5)(G), which excludes certain hedging income from the computation of the 95-percent income test, to exclude such hedging income from the computation of the 75-percent income test as well. As under present law, except to the extent determined by the Secretary of the Treasury, such income is income of a REIT from a hedging transaction (as defined in clause (ii) or (iii) of section 1221(b)(2)(A)), which is clearly identified pursuant to section 1221(a)(7), including gain from the sale or disposition of such a transaction, to the extent that the transaction hedges any indebtedness incurred or to be incurred by the REIT to acquire or carry real estate assets.

Second, the provision extends section 856(c)(5)(G) to encompass, (except to the extent determined by the Secretary of the Treasury), income of a REIT from a transaction entered into by the REIT primarily to manage risk of currency fluctuations with respect to any item of income or gain that would be qualified income under the 75-percent or 95-percent income tests, (or any property which generates such income or gain) provided the transaction is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may prescribe). Such income is excluded from gross income for purposes of both the 75-percent and 95-percent income tests.

Third, the rule that if a REIT has met the asset tests as of the close of any quarter it will not fail them solely because of a discrepancy due to variations in value that are not attributable to the acquisition of investments is clarified to include a discrepancy caused solely by the change in the foreign currency exchange rate used to value a foreign asset.[58]

Fourth, the term "cash" for purposes of the REIT asset qualification rules is defined to include foreign currency[59] if the REIT[60] or its QBU uses such currency as its functional currency, but only to the extent such foreign currency is held for use in the normal course of the activities of the REIT or the QBU giving rise to income or gain described in sections 856(c)(2) or (3), or directly related to acquiring or holding assets described in section 856(c)(4), and is not held in connection with a trade or business of trading or dealing in securities (as defined in section 475(c)(2).[61]

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[58] For example, suppose a REIT meets the 75-percent asset test as of the close of a quarter, but as of the close of the following quarter, a change in the foreign currency exchange rate has increased the value of certain foreign currency-denominated securities that are not qualifying assets for purposes of that test, such that the value of those securities exceeds the 25 percent permitted amount. If the REIT does not acquire any other asset during that next quarter, the REIT will not lose its status by reason of failure to meet the 75-percent asset test. However, if in that next quarter the REIT acquires another foreign-currency denominated (or any other) asset that is not a qualifying asset, and immediately after that acquisition the total value of non-qualifying assets, including the new acquisition, fails the test, then the REIT has until 30 days after the end of that quarter to adjust its asset value so that it satisfies the test.

[59] Although foreign currency thus may be considered a qualified asset for purposes of the 75-percent asset test of section 856(c)(4), foreign currency gain with respect to such currency is excluded income for purposes of the 75-percent or 95-percent income tests only to the extent such gain is attributable to the income items or other specific 988 transactions described in the rules of the provision that govern such income exclusions.

[60] Because a REIT must be a U.S. entity, it is normally required to use the dollar as its functional currency. However, under private rulings, the IRS has permitted REITs to use a functional currency other than the dollar where the operations and record-keeping requirements for treatment as a QBU that uses a functional currency other than the dollar are met. *See, e.g.,* PLR 200625019 and PLR 200550025. A private letter ruling may be relied upon only by the taxpayer to which the ruling was issued.

[61] This test applies to a REIT in determining whether it meets the 75-percent asset test. This test also independently applies to any QBU of a REIT in determining whether such QBU meets the 75-percent asset requirement. If that 75 percent asset requirement (along with the 75 percent income test) is met, then section 987 gain of the REIT attributable to that QBU is excluded from the REIT's gross income for the 75-percent and 95-percent income tests. In applying the 75-percent asset test to the REIT or a QBU, respectively, it is intended that currency held by such REIT or QBU, respectively, is treated as cash only to the extent used in the normal course of the activities of such REIT or QBU giving rise to income or gain described in sections 856(c)(2) or (3) or directly related to acquiring or holding assets described in section 856(c)(4) (other than such cash), and not held in connection with a trade or business of trading or dealing in securities (as defined in section 475(c)(2)).

Fifth, permitted foreclosure property income also includes foreign currency gain that is attributable to otherwise permitted income from foreclosure property.[62]

Finally, foreign currency gain under section 988(b)(1), or loss under section 988(b)(2), that is attributable to any prohibited transaction is taken into account in determining the amount of prohibited transaction net income subject to the 100-percent tax.

Treasury authority regarding other items of income

The provision authorizes the Treasury Department to issue guidance that would allow other items of income to be excluded for purposes of the computation of qualifying gross income under either the 75 percent or the 95 percent test, respectively, or to be included as qualifying income for either of such tests, respectively, in appropriate cases consistent with the purposes of the REIT provisions.[63]

Taxable REIT subsidiary limit increase

The provision increases the percentage of the value of REIT assets that can be held in securities of a taxable REIT subsidiary to 25 percent from the present 20 percent.[64]

Holding period under safe harbor for prohibited transactions

The provision shortens from four years to two years the minimum holding period under the prohibited transactions tax safe harbors of 857(b)(6)(C) and 857(b)(6)(D). The requirement that timber property under section 857(b)(6)(D) be sold to a qualified organization (as defined in section 170(h)(3)) exclusively for conservation purposes (as defined in section 170(h)(1)(C)) in order for the 2-year holding period to apply under the safe harbor, and the one-year limited application of the 2-year holding period rule under 857(b)(6)(D), are generally removed. The provision makes clear that the safe harbor is an exception from the prohibited transactions tax only, and does not cause a gain on a sale that otherwise does not qualify for capital gains treatment (i.e., because it was a sale of property held for sale to customers in the ordinary course of business under section 1221(a)(1)) to become a capital gain transaction.[65] Consequently, such

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[62] Such foreign currency gain is also included as foreclosure property income for purposes of any tax on such income under section 857(b)(4)(B)(i).

[63] Income that is statutorily excluded from gross income computations under the provision is not intended to be within the authority to include as qualifying income. In all cases, the Treasury regulatory authority applies solely for purposes of applying the relevant percentage tests for REIT qualification, and does not affect the substantive characterization of an item as income for purposes of computing the REIT's taxable income.

[64] The special 25 percent rule for timber REITs is made permanent under the provision, since timber REITs are treated in the same manner as other REITs for this purpose.

[65] In the case of a sale of timber property that qualifies for the safe harbor under section 857(b)(1)(D), for the one year period prescribed in the Food, Conservation and Energy Act of 2008, such a sale is considered to be a sale of property held for investment or use in a trade or business, and not of

capital gain treatment continues to be determined based on all the facts and circumstances as under present law, without regard to the prohibited transactions tax safe harbor. However, in the case of timber property under section 857(b)(6)(D), the provision retains for the one-year period prescribed in the Food, Energy and Conservation Act of 2008 the rule that qualification of the sale under the safe harbor also means that the sale is considered to be a sale of property held for investment or use in a trade or business, and not of property described in section 1221(a)(1), for all purposes of subtitle A of the Code, but only if the sale would have qualified under section 857(b)(6)(D) as in effect prior to the enactment of the provision.

Permitted extent of sales under safe harbor for prohibited transactions

The provision changes the prohibited transactions tax safe harbor provisions concerning maximum amount of sales within a taxable year that are consistent with the alternative prohibited transactions tax safe harbor (that is an alternative to the test for no more than 7 sales). Instead of the present alternative limit of 10-percent of the aggregate bases of all the assets of the REIT as of the beginning of the taxable year, the limit under the provision is either 10-percent of such aggregate basis or 10 percent of the aggregate fair market value of all the assets of the REIT as of such time.

Health care facilities held by a taxable REIT subsidiary

The provision expands the taxable REIT subsidiary exception for hotel, motel, and other transient facilities so that it also applies to health care facilities. Thus, a taxable REIT subsidiary is permitted to rent a health care facility from its parent REIT and hire an independent contractor to operate such a facility; the rents paid to the parent REIT are qualifying rental income for purposes of the 75-percent and 95-percent income tests.

Rules regarding operating a health care or lodging facility through an independent contractor

Under the provision, a taxable REIT subsidiary is not to be considered to be operating or managing a qualified health care property or a qualified lodging facility other than through an independent contractor solely because the taxable REIT subsidiary directly or indirectly possesses a license, permit, or similar instrument enabling it to do so.

Under the provision, a taxable REIT subsidiary is not to be considered to be operating or managing a qualified health care property or qualified lodging facility solely because it employs individuals working at such property or facility located outside the United States, but only if an eligible independent contractor is responsible for the daily supervision and direction of such individuals on behalf of the taxable REIT subsidiary pursuant to a management agreement or similar service contract.

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property described in section 1221(a)(1), for all purposes of subtitle A of the Code, for such one-year period.

Effective Date

The provision generally is effective for taxable years beginning after the date of enactment. However, the rules treating certain foreign currency gain as excluded income for purposes of the income tests apply to gain and items of income recognized after the date of enactment. The new rules of section 856(c)(5)(G), relating to hedging and managing risk, are effective for transactions entered into after such date of enactment. The Treasury authority to exclude items from income or to add items of qualifying income for purposes of the income qualification tests applies to gains and items of income recognized after the date of enactment. The foreign currency amendment relating to gain from foreclosure property applies to gain recognized after the date of enactment, and the provision relating to net prohibited transactions income applies to gain and deductions recognized after the date of enactment. The provisions relating to the prohibited transactions tax safe harbor apply to sales made after the date of enactment.

TITLE III – REVENUE PROVISIONS

A. General Provisions

1. Election to accelerate AMT and research credits in lieu of bonus depreciation (sec. 3081 of the bill and sec. 168(k) of the Code)

Present Law

Bonus depreciation

Taxpayers are permitted an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified property generally placed in service in 2008.[66] The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service. The basis of the property and the depreciation allowances in the year the property is placed in service and later years are appropriately adjusted to reflect the additional first-year depreciation deduction.

In order for property to qualify for the additional first-year depreciation deduction it must meet all of the following requirements: (1) the property must be (a) property to which MACRS applies with an applicable recovery period of 20 years or less, (b) water utility property (as defined in section 168(e)(5)), (c) computer software other than computer software covered by section 197, or (d) qualified leasehold improvement property (as defined in section 168(k)(3)); (2) the original use of the property must commence with the taxpayer after December 31, 2007; (3) the taxpayer must purchase the property either (a) after December 31, 2007, and before January 1, 2009, but only if no binding written contract for the acquisition is in effect before January 1, 2008, or (b) pursuant to a binding written contract which was entered into after December 31, 2007, and before January 1, 2009;[67] and (4) the property must be placed in service after December 31, 2007, and before January 1, 2009. An extension of the placed in service date of one year (i.e., to January 1, 2010) is provided for certain property with a recovery period of 10 years or longer and certain transportation property.

Corporate AMT credit

If a corporation is subject to the alternative minimum tax ("AMT") in any year, the amount of AMT paid is allowed as a credit in any subsequent taxable year to the extent the taxpayer's regular tax liability exceeds its tentative minimum tax.

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[66] H.R. 5140, section 103.

[67] Special rules apply to property manufactured, constructed, or produced by the taxpayer for use by the taxpayer.

Research credit

As part of the general business credit, section 38 limits credits for increasing research activities ("research credit") generally to the amount of regular tax in excess of tentative minimum tax.

Explanation of Provision

Corporations otherwise eligible for additional first year depreciation under section 168(k) may elect to claim additional research or minimum tax credits in lieu of claiming depreciation under section 168(k) for "eligible qualified property" placed in service after March 31, 2008.[68] A corporation making the election forgoes the depreciation deductions allowable under section 168(k) and instead increases the limitation under section 38(c) on the use of research credits or section 53(c) on the use of minimum tax credits. The increases in the allowable credits are treated as refundable for purposes of this provision. The depreciation for qualified property is calculated for both regular tax and AMT purposes using the straight-line method in place of the method that would otherwise be used absent the election under this provision.

The research credit or minimum tax credit limitation is increased by an amount equal to 20 percent of the bonus depreciation amount[69] for certain eligible qualified property that would be claimed absent an election under this provision. Generally, eligible qualified property included in the calculation is bonus depreciation property that meets the following requirements: (1) the original use of the property must commence with the taxpayer after March 31, 2008; (2) the taxpayer must purchase the property either (a) after March 31, 2008, and before January 1, 2009, but only if no binding written contract for the acquisition is in effect before April 1, 2008,[70] or (b) pursuant to a binding written contract which was entered into after March 31, 2008, and before January 1, 2009;[71] and (3) the property must be placed in service after March 31, 2008, and before January 1, 2009 (January 1, 2010 for certain longer-lived and transportation property).

The bonus depreciation amount is limited to the lesser of: (1) $30 million, or (2) six percent of the sum of research credit carryforwards from taxable years beginning before January 1, 2006 and minimum tax credits allocable to the adjusted minimum tax imposed for taxable

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[68] In the case of a electing corporation that is a partner in a partnership, the corporate partner's distributive share of partnership items is determined as if 168(k) does not apply to any eligible qualified property and the straight line method is used to calculate depreciation of such property.

[69] The bonus depreciation amount is the difference between the amount of depreciation, without regard to straight line elections, that would be determined if the election under this provision is not made and the amount if the election is made.

[70] In the case of passenger aircraft, the written binding contract limitation does not apply.

[71] Special rules apply to property manufactured, constructed, or produced by the taxpayer for use by the taxpayer.

years beginning before January 1, 2006. All corporations treated as a single employer under section 52(a) shall be treated as one taxpayer for purposes of the limitation, as well as for electing the application of this provision.

The provision also provides that an applicable partnership may elect to be treated as making a deemed payment of tax for any applicable taxable year in the amount of the least of the following: (1) the bonus depreciation amount that would be determined if an election under this provision were in effect for the partnership; (2) the amount of the partnership's research credit for the taxable year; or (3) $30 million (reduced by any deemed payment for any preceding taxable year). The deemed payment may not be used as an offset or credit against any tax liability of the partnership or any partner, but is instead refunded to the partnership. For purposes of this provision, an applicable partnership is a domestic partnership that was formed on August 3, 2007, and will produce in excess of 675,000 automobiles during the period beginning on January 1, 2008, and ending on June 30, 2008. An applicable taxable year is any taxable year during which eligible qualified property is placed in service. If an applicable partnership makes this election, the amount of the deduction allowable to the partnership or any partner for any eligible qualified property is computed without applying section 168(k), the straight line method must be used by the partnership and any partner for such property, the election to increase minimum tax credits and research credits under this provision is not available, and the research credit amount for any applicable taxable year with respect to the partnership is reduced by the amount of the deemed payment.

Effective Date

The provision is effective for taxable years ending after March 31, 2008.

2. Certain GO Zones incentives

(a) Election to amend returns for hurricane-related casualty losses (sec. 3082(a) of the bill)

Present Law

Under present law, a taxpayer may generally claim a deduction for any loss sustained during the taxable year and not compensated by insurance or otherwise.[72] For individual taxpayers, deductible losses must be incurred in a trade or business or other profit-seeking activity or consist of property losses arising from fire, storm, shipwreck, or other casualty, or from theft.[73] Generally, personal casualty or theft losses are deductible only if they exceed $100 per casualty or theft and net casualty and theft losses are deductible only to the extent it exceeds

[72] Sec. 165.

[73] Sec. 165(c)(3).

10 percent of adjusted gross income.[74] However, for hurricane-related casualty losses, these two casualty loss limitations are removed.[75]

Casualty losses are generally allowed for the taxable year of the loss. However, in the case of a disaster loss arising in an area determined by the President of the United States to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act, the taxpayer may elect to take the loss into account for the taxable year immediately before the taxable year in which the disaster occurred.[76]

When a taxpayer receives reimbursement for such loss in a subsequent taxable year, the deductible loss is not recomputed for the taxable year in which the deduction was taken, the reimbursement amount is taken into income in the taxable year received.[77]

Explanation of Provision

The provision allows a taxpayer who claimed a casualty loss to a principal residence (within the meaning of section 121) resulting from Hurricane Katrina, Hurricane Rita, or Hurricane Wilma and in a subsequent year receives a grant as reimbursement of such loss to elect to file an amended return for the taxable year to which such deduction was allowed.[78] The casualty loss deduction is reduced, but not below zero, by the amount of such reimbursement. The time for filing such amended return is the later of three years after the original due date for filing the tax return or four months after the date of enactment of this Act. Any underpayment of tax shall be subject to one year of interest, but no penalty or additional interest if paid not later than one year after the filing of the amended return.

Effective Date

The provision is effective on the date of enactment.

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[74] Sec. 165(h).

[75] Sec. 1400S(b).

[76] Sec. 165(i).

[77] Treas. Reg. sec. 165-1(d)(2)(iii).

[78] To qualify the grant must be received under Public Law 109-148, 109-234, or 110-116.

(b) Waiver of deadline on construction of GO Zone property eligible for bonus depreciation (sec. 3082(b) of the bill)

Present Law

In general

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS"). Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (other than residential rental property and nonresidential real property) range from three to 25 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

Gulf Opportunity Zone

The "Gulf Opportunity Zone" or "GO Zone" is defined as that portion of the Hurricane Katrina Disaster Area determined by the President to warrant individual or individual and public assistance from the Federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina. The term "Hurricane Katrina disaster area" means an area with respect to which a major disaster has been declared by the President before September 14, 2005, under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of Hurricane Katrina.

Gulf Opportunity Zone property

Present law provides an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified Gulf Opportunity Zone property. In order to qualify, property generally must be placed in service on or before December 31, 2007 (December 31, 2008 in the case of nonresidential real property and residential rental property).

The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service. The additional first-year depreciation deduction is subject to the general rules regarding whether an item is deductible under section 162 or subject to capitalization under section 263 or section 263A. The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, the provision provides that there is no adjustment to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies. A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.

In order for property to qualify for the additional first-year depreciation deduction, it must meet all of the following requirements. First, the property must be property (1) to which the general rules of the Modified Accelerated Cost Recovery System ("MACRS") apply with an

applicable recovery period of 20 years or less, (2) computer software other than computer software covered by section 197, (3) water utility property (as defined in section 168(e)(5)), (4) certain leasehold improvement property, or (5) certain nonresidential real property and residential rental property. Second, substantially all of the use of such property must be in the Gulf Opportunity Zone and in the active conduct of a trade or business by the taxpayer in the Gulf Opportunity Zone. Third, the original use of the property in the Gulf Opportunity Zone must commence with the taxpayer on or after August 28, 2005. (Thus, used property may constitute qualified property so long as it has not previously been used within the Gulf Opportunity Zone. In addition, it is intended that additional capital expenditures incurred to recondition or rebuild property the original use of which in the Gulf Opportunity Zone began with the taxpayer would satisfy the "original use" requirement. See Treasury Regulation 1.48-2 Example 5.) Finally, the property must be acquired by purchase (as defined under section 179(d)) by the taxpayer on or after August 28, 2005 and placed in service on or before December 31, 2007. For qualifying nonresidential real property and residential rental property, the property must be placed in service on or before December 31, 2008, in lieu of December 31, 2007. Property does not qualify if a binding written contract for the acquisition of such property was in effect before August 28, 2005. However, property is not precluded from qualifying for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to August 28, 2005.

Property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer qualifies if the taxpayer begins the manufacture, construction, or production of the property on or after August 28, 2005 and before January 1, 2008, and the property is placed in service on or before December 31, 2007 (and all other requirements are met). In the case of qualified nonresidential real property and residential rental property, the property must be placed in service on or before December 31, 2008. Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer.

Under a special rule, property any portion of which is financed with the proceeds of a tax-exempt obligation under section 103 is not eligible for the additional first-year depreciation deduction. Recapture rules apply under the provision if the property ceases to be qualified Gulf Opportunity Zone property.

<u>Gulf Opportunity Zone extension property</u>

The placed-in-service deadline is extended for specified Gulf Opportunity Zone extension property to qualify for the additional first-year depreciation deduction. Specified Gulf Opportunity Zone extension property is defined as property substantially all the use of which is in one or more specified portions of the Gulf Opportunity Zone and which is either: (1) nonresidential real property or residential rental property which is placed in service by the taxpayer on or before December 31, 2010, or (2) in the case of a taxpayer who places in service a

building described in (1), property described in section 168(k)(2)(A)(i)[79] placed in service on or before December 31, 2010, if substantially all the use of such property is in such building and such property is placed in service within 90 days of the date the building is placed in service. However, in the case of nonresidential real property or residential rental property, only the adjusted basis of such property attributable to manufacture, construction, or production before January 1, 2010 ("progress expenditures") is eligible for the additional first-year depreciation.

The specified portions of the Gulf Opportunity Zone are defined as those portions of the Gulf Opportunity Zone which are in a county or parish which is identified by the Secretary of the Treasury (or his delegate) as being a county or parish in which hurricanes occurring in 2005 damaged (in the aggregate) more than 60 percent of the housing units in such county or parish which were occupied (determined according to the 2000 Census). These areas include the Louisiana parishes of Calcasieu, Cameron, Orleans, Plaquemines, St. Bernard, St. Tammany, and Washington, and the Mississippi counties of Hancock, Harrison, Jackson, Pearl River, and Stone.[80]

Description of Proposal

The bill removes the commencement date of January 1, 2008, for self-constructed Gulf Opportunity Zone extension property. The placed in service date of December 31, 2010 and the progress expenditure date of January 1, 2010 are not modified.

Effective Date

The provision applies to property placed in service after December 31, 2007.

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[79] Property described in section 168(k)(2)(A)(i) includes (1) property to which the general rules of the Modified Accelerated Cost Recovery System ("MACRS") apply with an applicable recovery period of 20 years or less, (2) computer software other than computer software covered by section 197, (3) water utility property (as defined in section 168(e)(5)), and (4) certain leasehold improvement property.

[80] Notice 2007-36, 2007-17 I.R.B. 1000.

(c) Inclusion of certain counties in GO Zone for purposes of tax-exempt bond financing (sec. 3082(c) of the bill and sec. 1400N(a) of the Code)

Present Law

The Gulf Opportunity Zone Act of 2005 established certain tax benefits for areas affected by Hurricanes Katrina, Wilma and Rita.[81] Under present law, the "Gulf Opportunity Zone" or "GO Zone" means that portion of the Hurricane Katrina disaster area determined by the President to warrant individual or individual and public assistance from the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act (the "Stafford Act") by reason of Hurricane Katrina.[82] The "Hurricane Katrina disaster area" is the area with respect to which a major disaster has been declared by the President before September 14, 2005, under section 401 of the Stafford Act by reason of Hurricane Katrina.[83] The Code authorizes the States of Alabama, Louisiana and Mississippi to issue certain exempt facility bonds and qualified mortgage bonds for property located in the GO Zone ("GO Zone bonds").[84] In Alabama, the following counties have been identified as warranting individual or individual and public assistance: Baldwin, Chocktaw, Clarke, Greene, Hale, Marengo, Mobile, Pickens, Sumter, Tuscaloosa and Washington.[85]

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[81] Pub. L. No. 109-135.

[82] Sec. 1400M(1).

[83] Sec. 1400M(2).

[84] Sec. 1400N(a). For purposes of these bonds, qualified project costs are the cost of any qualified residential rental project (as defined in section 142(d)) located in the GO Zone, the cost of acquisition, construction, reconstruction and renovation of nonresidential real property (including fixed improvements associated with such property) located in the GO Zone, and the cost of acquisition, construction, reconstruction and renovation of public utility property (as defined in section 168(i)(10) located in the GO Zone (sec. 1400N(a)(4)). GO Zone bonds cannot be used for movable fixtures or equipment (sec. 1400N(a)(3)(B)). Nor can GO Zone bonds be used to provide any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling or any store the principal businesses of which is the sale of alcoholic beverages for consumption off premises (sec. 1400N(a)(2)(E) and sec. 144(c)(6)(B)). GO Zone bonds are treated as qualified mortgage bonds if the issue meets the general requirements of a qualified mortgage issue and the residences financed with such bonds are located in the GO Zone. For these residences, the first-time homebuyer rule is waived and purchase and income rules for targeted area residences apply. In addition, 100 percent of the mortgages must be made to mortgagors whose family income is 140 percent or less of the applicable median family income.

[85] Internal Revenue Service, Notice 2006-21, *GO Zone Resident Population Estimates* (March 20, 2006).

Explanation of Provision

For purposes of GO Zone bonds only, the provision includes the following counties for purposes of defining the GO Zone: Colbert County, Alabama and Dallas County, Alabama.

Effective Date

The provision is effective as if included in the Gulf Opportunity Zone Act of 2005 to which it relates.

B. Revenue Offsets

1. Require information reporting on payment card and third party payment transactions (sec. 3091 of the bill and new sec. 6050(W) of the Code)

Present Law

Present law imposes a variety of information reporting requirements on participants in certain transactions. These requirements are intended to assist taxpayers in preparing their income tax returns and to help the Internal Revenue Service ("IRS") determine whether such returns are correct and complete. For example, every person engaged in a trade or business generally is required to file information returns for each calendar year for payments of $600 or more made in the course of the payor's trade or business.[86] Payments to corporations generally are excepted from this requirement. Certain payments subject to information reporting also are subject to backup withholding if the payee has not provided a valid taxpayer identification number ("TIN").

Under present law, any person required to file a correct information return who fails to do so on or before the prescribed filing date is subject to a penalty that varies based on when, if at all, the correct information return is filed.

Explanation of Provision

The provision requires any payment settlement entity making payment to a participating payee in settlement of reportable payment transactions to report annually to the IRS and to the participating payee the gross amount of such reportable payment transactions, as well as the name, address, and TIN of the participating payees. A "reportable payment transaction" means any payment card transaction and any third party network transaction.

Under the provision, a "payment settlement entity" means, in the case of a payment card transaction, a merchant acquiring entity and, in the case of a third party network transaction, a third party settlement organization. A "participating payee" means, in the case of a payment card transaction, any person who accepts a payment card as payment and, in the case of a third party network transaction, any person who accepts payment from a third party settlement organization in settlement of such transaction.

For purposes of the reporting requirement, the term "merchant acquiring entity" means the bank or other organization with the contractual obligation to make payment to participating payees in settlement of payment card transactions. A "payment card transaction" means any transaction in which a payment card is accepted as payment.[87] A "payment card" is defined as

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[86] Sec. 6041(a). Unless otherwise stated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

[87] For this purpose, the acceptance as payment of any account number or other indicia associated with a payment card also qualifies a payment card transaction.

any card (e.g., a credit card or debit card) which is issued pursuant to an agreement or arrangement which provides for: (1) one or more issuers of such cards; (2) a network of persons unrelated to each other, and to the issuer, who agree to accept such cards as payment; and (3) standards and mechanisms for settling the transactions between the merchant acquiring entities and the persons who agree to accept such cards as payment. Thus, under the provision, a bank that enrolls a business to accept credit cards and contracts with the business to make payment on credit card transactions is required to report to the IRS the business's gross credit card transactions for each calendar year. The bank also is required to provide a copy of the information report to the business.

The provision also requires reporting on a third party network transaction. The term "third party network transaction" means any transaction which is settled through a third party payment network. A "third party payment network" is defined as any agreement or arrangement which (1) involves the establishment of accounts with a central organization by a substantial number of persons (e.g., more than 50) who are unrelated to such organization, provide goods or services, and have agreed to settle transactions for the provision of such goods or services pursuant to such agreement or arrangement; (2) which provides for standards and mechanisms for settling such transactions; and (3) which guarantees persons providing goods or services pursuant to such agreement or arrangement that such persons will be paid for providing such goods or services. In the case of a third party network transaction, the payment settlement entity is the third party settlement organization, which is defined as the central organization which has the contractual obligation to make payment to participating payees of third party network transactions. Thus, an organization generally is required to report if it provides a network enabling buyers to transfer funds to sellers who have established accounts with the organization and have a contractual obligation to accept payment through the network. However, an organization operating a network which merely processes electronic payments (such as wire transfers, electronic checks, and direct deposit payments) between buyers and sellers, but does not have contractual agreements with sellers to use such network, is not required to report under the provision. Similarly, an agreement to transfer funds between two demand deposit accounts will not, by itself, constitute a third party network transaction.

A third party payment network does not include any agreement or arrangement which provides for the issuance of payment cards as defined by the provision. In addition, a third party settlement organization is not required to report unless the aggregate value of third party network transactions for the year exceeds $20,000 and the aggregate number of such transactions exceeds 200. For the avoidance of doubt, if a payment of funds is made *to* a third party settlement organization by means of a payment card (i.e., as part of a transaction that is a payment card transaction), the $20,000 and 200 transaction *de minimis* rule continues to apply to any reporting obligation with respect to payment of such funds to a participating payee *by* the third party settlement organization made as part of a third party network transaction.

The provision also imposes reporting requirements on intermediaries who receive payments from a payment settlement entity and distribute such payments to one or more participating payees. The provision treats such intermediaries as participating payees with respect to the payment settlement entity and as payment settlement entities with respect to the participating payees to whom the intermediary distributes payments. Thus, for example, in the case of a corporation that receives payment from a bank for credit card sales effectuated at the

corporation's independently-owned franchise stores, the bank is required to report the gross amount of reportable payment transactions settled through the corporation (notwithstanding the fact that the corporation does not accept payment cards and would not otherwise be treated as a participating payee). In turn, the corporation, as an intermediary, would be required to report the gross amount of reportable payment transactions allocable to each franchise store. The bank would have no reporting obligation with respect to payments made by the corporation to its franchise stores.

If a payment settlement entity contracts with a third party to settle reportable payment transactions on behalf of the payment settlement entity, the provision requires the third party to file the annual information return in lieu of the payment settlement entity.

The provision grants authority to the Secretary to issue guidance to implement the reporting requirement, including rules to prevent the reporting of the same transaction more than once.

Under the provision, reportable payment transactions subject to information reporting generally are subject to backup withholding requirements. Finally, present law penalties relating to the failure to file correct information returns would apply to the new information reporting requirements required under the provision.

Effective Date

The provision generally is effective for information returns for reportable payment transactions for calendar years beginning after December 31, 2010. The amendments to the backup withholding requirements apply to amounts paid after December 31, 2011.

2. Exclusion of gain on sale of a principal residence not to apply to nonqualified use (sec. 3092 of the bill and sec. 121 of the Code)

Present Law

In general

Under present law, an individual taxpayer may exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. To be eligible for the exclusion, the taxpayer must have owned and used the residence as a principal residence for at least two of the five years ending on the sale or exchange. A 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 able to exclude an amount equal to the fraction of the $250,000 ($500,000 if married filing a joint return) that is equal to the fraction of the two years that the ownership and use requirements are met.

Present law also contains an election relating to members of the uniformed services, the Foreign Service, and certain employees of the intelligence community.[88] If the election is made, the five-year period ending on the date of the sale or exchange of a principal residence does not include any period up to 10 years during which the taxpayer or the taxpayer's spouse is on qualified official extended duty. For these purposes, qualified official extended duty is any period of extended duty while serving at a place of duty at least 50 miles away from the taxpayer's principal residence or under orders compelling residence in government furnished quarters. The election may be made with respect to only one property for a suspension period.

The exclusion does not apply to gain to the extent the gain is attributable to depreciation allowable with respect to the rental or business use of a principal residence for periods after May 6, 1997.

Explanation of Provision

Under the bill, gain from the sale or exchange of a principal residence allocated to periods of nonqualified use is not excluded from gross income. 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 taxpayer and the denominator of which is the period the taxpayer owned the property.

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 taxpayer or the taxpayer's spouse or former spouse as a principal residence. For purposes of determining periods of nonqualified use, (i) any period after the last date the property is used as the principal residence of the taxpayer or spouse (regardless of use during that period), and (ii) any period (not to exceed two years) that the taxpayer 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 present-law election for the uniformed services, Foreign Service and employees of the intelligence community is unchanged.

If any gain is attributable to post-May 6, 1997, depreciation, the exclusion does not apply to that amount of gain, as under present law, and that gain is not taken into account in determining the amount of gain allocated to nonqualified use.

These provisions may be illustrated by the following examples:

Example 1.–Assume that an individual buys a property on January 1, 2009, for $400,000, and uses it as rental property for two years claiming $20,000 of depreciation deductions. On January 1, 2011, the taxpayer converts the property to his principal residence. On January 1, 2013, the taxpayer moves out, and the taxpayer sells the property for $700,000 on January 1, 2014. As under present law, $20,000 gain attributable to the depreciation deductions is included in income. Of the remaining $300,000 gain, 40% of the gain (2 years divided by 5 years), or

[88] The provision relating to employees of the intelligence community is effective for sales and exchanges before January 1, 2011.

$120,000, is allocated to nonqualified use and is not eligible for the exclusion. Since the remaining gain of $180,000 is less than the maximum gain of $250,000 that may be excluded, gain of $180,000 is excluded from gross income.

Example 2.–Assume that an individual buys a principal residence on January 1, 2009, for $400,000, moves out on January 1, 2019, and on December 1, 2021 sells the property for $600,000. The entire $200,000 gain is excluded from gross income, as under present law, because periods after the last qualified use do not constitute nonqualified use.

Effective Date

The provision is effective for sales and exchanges after December 31, 2008.

3. Delay implementation of worldwide interest allocation (sec. 3093 of the bill and sec. 864(f) of the Code)

Present Law

In general

In order to compute the foreign tax credit limitation, a taxpayer must determine the amount of its taxable income from foreign sources. Thus, the taxpayer must allocate and apportion deductions between items of U.S.-source gross income, on the one hand, and items of foreign-source gross income, on the other.

In the case of interest expense, the rules generally are based on the approach that money is fungible and that interest expense is properly attributable to all business activities and property of a taxpayer, regardless of any specific purpose for incurring an obligation on which interest is paid.[89] For interest allocation purposes, all members of an affiliated group of corporations generally are treated as a single corporation (the so-called "one-taxpayer rule") and allocation must be made on the basis of assets rather than gross income. The term "affiliated group" in this context generally is defined by reference to the rules for determining whether corporations are eligible to file consolidated returns.

For consolidation purposes, the term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation, but only if: (1) the common parent owns directly stock possessing at least 80 percent of the total voting power and at least 80 percent of the total value of at least one other includible corporation; and (2) stock meeting the same voting power and value standards with respect to each includible corporation (excluding the common parent) is directly owned by one or more other includible corporations.

[89] However, exceptions to the fungibility principle are provided in particular cases, some of which are described below.

Generally, the term "includible corporation" means any domestic corporation except certain corporations exempt from tax under section 501 (for example, corporations organized and operated exclusively for charitable or educational purposes), certain life insurance companies, corporations electing application of the possession tax credit, regulated investment companies, real estate investment trusts, and domestic international sales corporations. A foreign corporation generally is not an includible corporation.

Subject to exceptions, the consolidated return and interest allocation definitions of affiliation generally are consistent with each other.[90] For example, both definitions generally exclude all foreign corporations from the affiliated group. Thus, while debt generally is considered fungible among the assets of a group of domestic affiliated corporations, the same rules do not apply as between the domestic and foreign members of a group with the same degree of common control as the domestic affiliated group.

Banks, savings institutions, and other financial affiliates

The affiliated group for interest allocation purposes generally excludes what are referred to in the Treasury regulations as "financial corporations" (Treas. Reg. sec. 1.861-11T(d)(4)). These include any corporation, otherwise a member of the affiliated group for consolidation purposes, that is a financial institution (described in section 581 or section 591), the business of which is predominantly with persons other than related persons or their customers, and which is required by State or Federal law to be operated separately from any other entity which is not a financial institution (sec. 864(e)(5)(C)). The category of financial corporations also includes, to the extent provided in regulations, bank holding companies (including financial holding companies), subsidiaries of banks and bank holding companies (including financial holding companies), and savings institutions predominantly engaged in the active conduct of a banking, financing, or similar business (sec. 864(e)(5)(D)).

A financial corporation is not treated as a member of the regular affiliated group for purposes of applying the one-taxpayer rule to other non-financial members of that group. Instead, all such financial corporations that would be so affiliated are treated as a separate single corporation for interest allocation purposes.

Worldwide interest allocation

In general

The American Jobs Creation Act of 2004 ("AJCA")[91] modifies the interest expense allocation rules described above (which generally apply for purposes of computing the foreign tax credit limitation) by providing a one-time election (the "worldwide affiliated group election") under which the taxable income of the domestic members of an affiliated group from sources

[90] One such exception is that the affiliated group for interest allocation purposes includes section 936 corporations that are excluded from the consolidated group.

[91] Pub. L. No. 108-357, sec. 401 (2004).

outside the United States generally is determined by allocating and apportioning interest expense of the domestic members of a worldwide affiliated group on a worldwide-group basis (i.e., as if all members of the worldwide group were a single corporation). If a group makes this election, the taxable income of the domestic members of a worldwide affiliated group from sources outside the United States is determined by allocating and apportioning the third-party interest expense of those domestic members to foreign-source income in an amount equal to the excess (if any) of (1) the worldwide affiliated group's worldwide third-party interest expense multiplied by the ratio which the foreign assets of the worldwide affiliated group bears to the total assets of the worldwide affiliated group,[92] over (2) the third-party interest expense incurred by foreign members of the group to the extent such interest would be allocated to foreign sources if the principles of worldwide interest allocation were applied separately to the foreign members of the group.[93]

For purposes of the new elective rules based on worldwide fungibility, the worldwide affiliated group means all corporations in an affiliated group as well as all controlled foreign corporations that, in the aggregate, either directly or indirectly,[94] would be members of such an affiliated group if section 1504(b)(3) did not apply (i.e., in which at least 80 percent of the vote and value of the stock of such corporations is owned by one or more other corporations included in the affiliated group). Thus, if an affiliated group makes this election, the taxable income from sources outside the United States of domestic group members generally is determined by allocating and apportioning interest expense of the domestic members of the worldwide affiliated group as if all of the interest expense and assets of 80-percent or greater owned domestic corporations (i.e., corporations that are part of the affiliated group, as modified to include insurance companies) and certain controlled foreign corporations were attributable to a single corporation.

The common parent of the domestic affiliated group must make the worldwide affiliated group election. It must be made for the first taxable year beginning after December 31, 2008, in which a worldwide affiliated group exists that includes at least one foreign corporation that meets the requirements for inclusion in a worldwide affiliated group. Once made, the election applies to the common parent and all other members of the worldwide affiliated group for the taxable year for which the election was made and all subsequent taxable years, unless revoked with the consent of the Secretary of the Treasury.

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[92] For purposes of determining the assets of the worldwide affiliated group, neither stock in corporations within the group nor indebtedness (including receivables) between members of the group is taken into account.

[93] Although the interest expense of a foreign subsidiary is taken into account for purposes of allocating the interest expense of the domestic members of the electing worldwide affiliated group for foreign tax credit limitation purposes, the interest expense incurred by a foreign subsidiary is not deductible on a U.S. return.

[94] Indirect ownership is determined under the rules of section 958(a)(2) or through applying rules similar to those of section 958(a)(2) to stock owned directly or indirectly by domestic partnerships, trusts, or estates.

Financial institution group election

Taxpayers are allowed to apply the bank group rules to exclude certain financial institutions from the affiliated group for interest allocation purposes under the worldwide fungibility approach. The rules also provide a one-time "financial institution group" election that expands the bank group. At the election of the common parent of the pre-election worldwide affiliated group, the interest expense allocation rules are applied separately to a subgroup of the worldwide affiliated group that consists of (1) all corporations that are part of the bank group, and (2) all "financial corporations." For this purpose, a corporation is a financial corporation if at least 80 percent of its gross income is financial services income (as described in section 904(d)(2)(C)(i) and the regulations thereunder) that is derived from transactions with unrelated persons.[95] For these purposes, items of income or gain from a transaction or series of transactions are disregarded if a principal purpose for the transaction or transactions is to qualify any corporation as a financial corporation.

The common parent of the pre-election worldwide affiliated group must make the election for the first taxable year beginning after December 31, 2008, in which a worldwide affiliated group includes a financial corporation. Once made, the election applies to the financial institution group for the taxable year and all subsequent taxable years. In addition, anti-abuse rules are provided under which certain transfers from one member of a financial institution group to a member of the worldwide affiliated group outside of the financial institution group are treated as reducing the amount of indebtedness of the separate financial institution group. Regulatory authority is provided with respect to the election to provide for the direct allocation of interest expense in circumstances in which such allocation is appropriate to carry out the purposes of these rules, to prevent assets or interest expense from being taken into account more than once, or to address changes in members of any group (through acquisitions or otherwise) treated as affiliated under these rules.

Effective date of worldwide interest allocation under AJCA

The worldwide interest allocation rules under AJCA are effective for taxable years beginning after December 31, 2008.

Explanation of Provision

The provision delays the effective date of worldwide interest allocation rules for two years, until taxable years beginning after December 31, 2010. The required dates for making the worldwide affiliated group election and the financial institution group election are changed accordingly.

The provision also provides a special phase-in rule in the case of the first taxable year to which the worldwide interest allocation rules apply. For that year, the amount of the taxpayer's taxable income from foreign sources is reduced by 70 percent of the excess of (i) the amount of its taxable income from foreign sources as calculated using the worldwide interest allocation

[95] See Treas. Reg. sec. 1.904-4(e)(2).

rules over (ii) the amount of its taxable income from foreign sources as calculated using the present-law interest allocation rules. Any foreign tax credits disallowed by virtue of this reduction in foreign-source taxable income may be carried back or forward under the normal rules for carrybacks and carryforwards of excess foreign tax credits.

Effective Date

The provision is effective on the date of enactment.

4. Modifications to corporate estimated tax payments (sec. 3094 of the bill)

Present Law

In general

In general, corporations are required to make quarterly estimated tax payments of their income tax liability. For a corporation whose taxable year is a calendar year, these estimated tax payments must be made by April 15, June 15, September 15, and December 15.

Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA")

TIPRA provided the following special rules:

In case of a corporation with assets of at least $1 billion, the payments due in July, August, and September, 2012, shall be increased to 106.25 percent of the payment otherwise due and the next required payment shall be reduced accordingly.

In case of a corporation with assets of at least $1 billion, the payments due in July, August, and September, 2013, shall be increased to 100.75 percent of the payment otherwise due and the next required payment shall be reduced accordingly.

Subsequent legislation

Several public laws have been enacted since TIPRA which further increase the percentage of payments due under each of the two special rules enacted by TIPRA described above.

Explanation of Provision

The provision makes two modifications to the corporate estimated tax payment rules.

First, in case of a corporation with assets of at least $1 billion, the payments due in July, August, and September, 2013, are increased by 16.75 percent points of the payment otherwise due and the next required payment shall be reduced accordingly.

Second, in case of a corporation with assets of at least $1 billion, the increased payments due in July, August, and September, 2012 under the special rules in TIPRA and subsequent legislation are repealed. In effect the general rule is applied (i.e., such corporations are required to make quarterly estimated tax payments based on their income tax liability.)

Effective Date

The provision is effective on the date of enactment.