PUBLICATION

New Housing Recovery Act Provides Major Tax Incentives to Aid Real Estate Market and Businesses

July 30, 2008

On July 30, 2008, the President signed The Housing and Economic Recovery Act of 2008 (the Housing Act) into law. The Housing Act contains three distinct divisions: Division A, which addresses housing finance reform and the rescue of FNMA and FHLMC; Division B, which provides for foreclosure prevention; and Division C, which contains tax incentives, reforms and revenue offsets.

This Alert will discuss the major tax provisions contained in Division C, which is entitled The Housing Assistance Tax Act of 2008 (the Act) and is intended to aid homeowners and home buyers, bolster the sagging real estate market, provide additional relief to Gulf Opportunity Zone (GO Zone) individuals and businesses, and subject taxpayers to added tax burdens and reporting requirements.

Assistance to Housing Market

Credit for First-Time Homebuyers, with a Catch

The Act provides a first-time homebuyer credit that is economically similar to an interest-free loan. For home purchases made between April 9, 2008, and July 1, 2009, first-time homebuyers can receive a refundable tax credit of 10 percent of the purchase price of a principal residence, up to $7,500 for joint filers and $3,750 for single taxpayers. The credit begins to phase out at higher incomes: $150,000 for joint filers and $75,000 for singles. The new provision treats as a first-time homebuyer any person who had no ownership interest in a principal residence in the United States during the 3-year period before the home purchase to which the credit applies. Recipients of this tax credit must repay the credit amount to the government over 15 years in equal installments, starting in the second taxable year after the taxable year of the home purchase. If the taxpayer sells the home for a gain or does not use the home as a principal residence before repaying the credit, the unpaid amount becomes fully due in that year.

Property Tax Deduction for Non-ItemizersEffective only for the 2008 tax year, non-itemizing homeowners are entitled to a standard deduction of up to $500 ($1,000 for joint filers) for state and local real property taxes.

Expansion of Low-Income Housing Tax Credits

The Act made several changes to the low-income housing (LIH) tax credit rules, which are intended to result in additional housing units for low-income families. Each state can allocate a certain amount of LIH credits based in part on state population. In general, each state may allocate a total amount equal to $2.00 per person residing in the state, but the Act increases this amount by 20 cents for 2008 and 2009 only. The Act also modifies several technical rules relating to the LIH credit.

The Act permanently expands the type of buildings eligible for the credit. The Act temporarily fixes the applicable credit percentage (which determines the taxpayer's credit amount) at 9 percent for newly constructed non-Federally subsidized buildings placed in service after the date of enactment and before December 31, 2013. The Act provides State housing agencies with greater flexibility to select project sites and allocate credits. The Act also allows developers one year instead of six months to begin construction of low-income housing projects after the credits have been awarded. Several other technical modifications expand the availability of the LIH credit by relaxing income and community requirements, among other changes.

Taxpayers also may now use the LIH tax credit to offset alternative minimum tax (AMT) liability. The changes to the LIH tax credit are generally effective for buildings placed in service after July 30, 2008.

Expanded Support for Housing-Related Bonds
The Act authorizes an additional $11 billion in qualified mortgage bonds or private activity bonds in 2008 for rental housing, and temporarily allows qualified mortgage revenue bonds to be used to refinance certain subprime loans. The Act excludes tax-exempt interest associated with qualified residential bonds for AMT purposes and allows the low-income housing tax credit and rehabilitation credits to offset AMT liability. The Act also provides a temporary provision allowing municipal bonds guaranteed by Federal home loan banks to qualify as tax-exempt bonds (with the resulting interest exempt from Federal tax), regardless of whether such bonds are used to finance housing programs. The Act also relaxes restrictions on the rehabilitation tax credit and on mortgage revenue bonds used to help individuals purchase new homes in Presidentially-declared disaster areas if the bonds are issued after May 1, 2008 and before January 1, 2010.

New Limitation on Excluded Gain from Sale of Principal Residence
The Act increases taxable income for certain home sellers. In general, a taxpayer may exclude up to $250,000 ($500,000 if married filing jointly) of gain realized on the sale or exchange of a home, if the taxpayer owned and used the residence as a principal residence for at least two of the previous five years. Under the Act, gain 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 the portion of the taxpayer's ownership period that the property was used for a nonqualified use. A period of nonqualified use means any period after 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 example, assume you buy a home on March 1, 2009 for $200,000, and you rent the property for two years. You live in the property as your principal residence from March 1, 2011 until you sell the property on March 1, 2014 for $300,000. You have owned the property for five years, and have used it as your principal residence for three years. Prior to the Act, you could exclude the entire $100,000 of gain. Now, $40,000 of the $100,000 of gain (attributable to the two years of rental out of five years of ownership) will be ineligible for the exclusion and will be taxable income. The remaining $60,000 will continue to be excluded.

Assistance to Businesses and Individuals

Choice of bonus depreciation or additional AMT and research credits
Taxpayers currently are permitted an additional first-year depreciation deduction under section 168(k) equal to 50 percent of the adjusted basis of qualified property generally placed in service in 2008. The Act allows corporations otherwise eligible for additional first year depreciation to elect additional research and development credits or AMT credits in lieu of such depreciation deductions. If a corporation makes the election, the research credit or AMT credit limitation is increased by 20 percent of the bonus depreciation amount to which the taxpayer would be entitled absent the election. The increases in the allowable credits are treated as refundable for purposes of this provision, but the bonus depreciation amount on which the credit is computed is limited to the lesser of 6 percent of the total credits accumulated from 2005 and earlier or $30 million.

- ***Extension of deadline on self-constructed GO Zone property eligible for bonus depreciation.*** Existing law provides an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified GO Zone property. In order for property to qualify for the additional first-year depreciation deduction, it must meet various technical requirements. One requirement for certain self-constructed GO Zone property was that the taxpayer must have commenced the manufacture, construction, or production of the property before January 1, 2008. The Act eliminates this commencement date requirement for self-constructed GO Zone extension property, effective for

property placed in service after December 31, 2007. The Act provides that whether property is qualified GO Zone property is determined "without regard" to the construction commencement date deadline. Taxpayers seeking to take advantage of this provision with respect to GO Zone property on which construction began on or after January 1, 2008 should discuss the scope of this amendment with their advisors. The Act, however, does not change the deadline for taxpayers to place self-constructed GO Zone extension property in service, which generally is on or before December 31, 2010.

- ***Alabama counties added to GO Zone bond provisions.*** The Act includes Colbert and Dallas Counties in Alabama as eligible counties for GO Zone bond issuance purposes. This provision is effective as of December 21, 2005, the date of enactment of the GO Zone Act of 2005.
- ***Election to amend returns for hurricane-related casualty losses.*** Taxpayers generally may deduct casualty losses that are sustained during the taxable year and not compensated by insurance or otherwise. If a taxpayer is reimbursed for such a loss in a later year, the taxpayer ordinarily takes the reimbursement amount into income in that year instead of recomputing the deductible loss for the prior year. The Act changes this result for taxpayers who claimed casualty losses resulting from Hurricanes Katrina, Rita or Wilma. If such a taxpayer receives reimbursement for the previously deducted casualty loss, the taxpayer may elect to file an amended return for the taxable year to which such casualty loss deduction was allowed. The casualty loss deduction is reduced, but not below zero, by the amount of the reimbursement. The amended return will be due on the later of the due date for filing the tax return for the taxable year in which the taxpayer receives the grant or one year after the date of enactment, which is July 30, 2009. No interest or penalties will be due on the amended return, if the tax due on such amended return is paid not later than one year after the filing of such amended return.

Real Estate Investment Trust Reforms

The Act modifies several technical REIT provisions, which will be the subject of a separate Tax Alert issued by Baker Donelson. Many of these changes affect the calculation of qualified REIT income. The Act clarifies that REITs may earn foreign currency income associated with real estate activities, and authorizes the Treasury to exclude other items of income for REIT qualification purposes. The Act also increases the percentage of total REIT assets that investments in taxable REIT subsidiaries may constitute from 20% to 25% of the parent REIT's value. Special rules for lodging facilities now extend to health care facilities so that a taxable REIT subsidiary may rent a health care facility from its parent REIT and hire an independent contractor to operate such a facility without the rents paid adversely affecting the REIT income tests. The Act also relaxes the REIT safe harbor for dealer sales by shortening the minimum holding period to avoid prohibited transaction treatment.

Worldwide Interest Allocation for Foreign Tax Credit Delayed

The American Jobs Creation Act of 2004 (AJCA) allowed corporations a one-time election that would assist some U.S. companies with worldwide operations in computing the foreign tax credit limitation. With the election, foreign source taxable income of the domestic members of an affiliated group would be determined by allocating and apportioning interest expense of a worldwide affiliated group as if all members of the worldwide group were a single corporation. Prior to the AJCA, a company would divide stock value by the company's assets, and multiply the result by domestic interest expense, which was then applied to reduce income for purposes of the foreign tax credit. Debt owed by foreign affiliates did not count. Under the AJCA change, foreign debt is included, which has a net effect of allocating more interest as U.S. source and increasing the foreign tax credit limitation. The Act delays the availability of the worldwide interest allocation election for two years, until tax years beginning after December 31, 2010, and also provides a special phase-in rule for 2011, the first taxable year to which the election applies.

More Changes for Corporate Estimated Tax Payments
Corporations are required to make quarterly estimated tax payments of their income tax liability. In recent years, Congress has created special rules increasing the required corporate estimated tax payments for corporations with assets of $1 billion or more. For these corporations, Congress had increased some of the required monthly estimated tax payments for 2012 and 2013 to amounts in excess of 100 percent of the amounts otherwise due. The Act eliminates the required excess payments for 2012, and increases the excess amounts due for certain of the 2013 payments by 16.75 percentage points, with subsequent payments reduced accordingly.

New Information Reporting for Merchant Payment Card Transactions
The Act requires institutions that make payments to merchants in settlement of payment card (credit or debit card) transactions to file an information return with the Internal Revenue Service. The Act also requires information returns for similar payments in settlement of certain third party network transactions, such as online retailers. These reporting requirements are designed to help prevent merchants from underreporting their business income, and they are effective for sales made on or after January 1, 2011.

Effective Dates

Except as noted elsewhere in this Alert, the provisions of the Act are effective upon the date of enactment, which is July 30, 2008.