

E. Real Estate Provisions

1. Tax credit for rehabilitation expenditures (sec. 251 of the Act and secs. 46(b), 48(g), and 48(q) of the Code)³⁹

Prior Law

A three-tier investment tax credit was provided for qualified rehabilitation expenditures. The credit was 15 percent for nonresidential buildings at least 30 years old, 20 percent for nonresidential buildings at least 40 years old, and 25 percent for certified historic structures (including residential buildings). A certified historic structure was defined as a building (and its structural components) that is listed in the National Register of Historic Places, or is located in a registered historic district and certified by the Secretary of the Interior as being of historic significance to the district.

The rehabilitation credit was available only if the taxpayer elected to use the straight-line method of cost recovery with respect to the rehabilitation expenditures. If the 15- or 20-percent investment credit was allowed for qualified rehabilitation expenditures, the basis of the property was reduced by the amount of credit earned (and the reduced basis was used to compute cost recovery deductions) (sec. 48(q)(1) and (3)). The basis was reduced by 50 percent of the 25-percent credit allowed for the rehabilitation of certified historic structures.

Qualified rehabilitation expenditures were eligible for the credit only if incurred in connection with a substantial rehabilitation that satisfied an external-walls requirement. The test of substantial rehabilitation generally was met if the qualified expenditures during a 24-month measuring period exceeded the greater of the adjusted basis of the building as of the first day of the 24-month period, or \$5,000. (In phased rehabilitations, the 24-month measuring period was extended to 60 months.)

The external-walls requirement provided generally that at least 75 percent of the existing external walls of the building had to be retained in place as external walls in the rehabilitation process. An alternative test provided that the external-walls requirement was met if (1) at least 75 percent of the external walls were retained in place as either internal or external walls, (2) at least 50 percent of such walls were retained in place as external walls, and (3) at least 75 percent of the building's internal structural framework was retained in place.

In the case of rehabilitations of certified historic structures, certain additional rules applied. In particular, the Secretary of the In-

³⁹ For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 232; H. Rep. 99-426, pp. 185-190; H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1412; S.Rep. 99-313, pp. 752-756; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 82-83 (Conference Report).

terior had to certify that the rehabilitation was consistent with the historic character of the building or the historic district in which the building was located. In fulfilling this statutory mandate, the Secretary of the Interior's Standards for Rehabilitation were applied. See 36 CFR Part 67.7 (March 12, 1984).

Qualified rehabilitation expenditures generally included any amounts properly chargeable to capital account of a building in connection with a rehabilitation, but did not include the following:

(1) the cost of acquiring a building or an interest in a building (such as a leasehold interest);

(2) the cost of facilities related to a building (such as a parking lot); and

(3) the cost of enlarging an existing building.

Lessees were entitled to the credit for qualified expenditures incurred by the lessee if, on the date the rehabilitation was completed, the remaining lease term (without regard to renewal periods) was at least as long as the applicable recovery period (generally 19 years; 15 years in the case of low-income housing). Under regulations prescribed by the Secretary of the Treasury, the substantial rehabilitation test for a lessee was generally applied by comparing the lessee's qualified rehabilitation expenditures to the lessor's adjusted basis in the building (i.e., the lessee stepped into the shoes of the lessor).

The rehabilitation credit was subject to recapture if the rehabilitated building was disposed of or otherwise ceased to be qualified investment credit property with respect to the taxpayer during the five years following the date the property was placed in service. If the Department of the Interior decertified a rehabilitation of a certified historic structure during the recapture period, the property ceased to be qualified investment credit property.

Reasons for Change

In 1981, the Congress restructured and increased the tax credit for rehabilitation expenditures. The Congress was concerned that the tax incentives provided to investments in new structures (e.g., accelerated cost recovery) would have the undesirable effect of reducing the relative attractiveness of the prior-law incentives to rehabilitate and modernize older structures, and might lead investors to neglect older structures and relocate their businesses.

The Congress concluded that the incentives granted to rehabilitations in 1981 remain justified. Such incentives are needed because the social and aesthetic values of rehabilitating and preserving older structures are not necessarily taken into account in investors' profit projections. A tax incentive is needed because market forces might otherwise channel investments away from such projects because of the extra costs of undertaking rehabilitations of older or historic buildings.

The Congress also sought to focus the credit particularly on historic and certain older buildings, to insure that the credits accomplish their intended objectives of preserving such historic and older buildings. In addition, the Congress was concerned that the existing credit percentages would be too high in the context of the lower overall rates provided in the Act. For example, the 25-percent

credit under prior law offset tax on 50 cents of income for every \$1 of rehabilitation expenditures made by an individual taxpayer in the top 50-percent bracket. A credit of 14 percent would accomplish the same offset to income with a top bracket of 28 percent. Similarly reduced credits would reproduce the same offsets to income as the current 15-percent and 20-percent rehabilitation credits.

Explanation of Provision

Two-tier credit

The Act replaces the existing three-tier rehabilitation credit with a two-tier credit for qualified rehabilitation expenditures. The credit percentage is 20 percent for rehabilitations of certified historic structures and 10 percent for rehabilitations of buildings (other than certified historic structures) originally placed in service before 1936.

Retention of certain rules

As under prior law, the 10-percent credit for the rehabilitation of buildings that are not certified historic structures is limited to non-residential buildings, but the 20-percent credit for rehabilitation of historic buildings is available for both residential and nonresidential buildings.

The prior law provisions that determine whether rehabilitation expenditures qualify for the credit were generally retained. In general, no changes were made regarding the substantial rehabilitation test, the specific types of expenditures that do not qualify for the credit, the provisions applicable to certified historic structures and tax-exempt use property, or the recapture rules.

No expenditure will be eligible for credit unless the taxpayer recovers the costs of the rehabilitation using the straight-line method of depreciation. Further, expenditures incurred by a lessee will not qualify for the credit unless the remaining lease term, on the date the rehabilitation is completed, is at least as long as the recovery period under ACRS (generally 27.5 years for residential real property or 31.5 years for nonresidential real property).

External-walls requirement

The external-walls requirement was significantly modified. The provision that requires 75 percent of the existing external walls to be retained in place as external walls was deleted and replaced by the alternative test provided by prior law that requires the retention in place of (1) at least 75 percent of the existing external walls (including at least 50 percent as external walls) as well as (2) at least 75 percent of the building's internal structural framework. Thus, unlike the situation that could occur under prior law, a building that is completely gutted cannot qualify for the rehabilitation credit under the Act. In general, a building's internal structural framework includes all load-bearing internal walls and any other internal structural supports, including the columns, girders, beams, trusses, spandrels, and all other members that are essential to the stability of the building.

Because the Secretary of the Interior's Standards for Rehabilitation insure that certified historic structures are properly rehabili-

tated, the external-walls requirement for such buildings was deleted to provide the Secretary of the Interior with appropriate flexibility. Rehabilitations eligible for the 20-percent credit must continue to be true rehabilitations, however, and not substantially new construction. Therefore, the Secretary of the Interior is expected to continue generally to deny certification to rehabilitations if less than 75 percent of the external walls are retained in place.

Basis reduction

The Act deletes the limited exception that required a basis reduction for only 50 percent of the credit in the case of certified historic structures. Thus, a full basis adjustment is required for both the ten-percent and 20-percent rehabilitation credits.

Effective Date

The modifications to the rehabilitation credit are generally applicable to property placed in service after December 31, 1986.

A general transitional rule provides that the modifications to the rehabilitation credit (other than certain reductions in the credit percentage—see below) will not apply to property placed in service before January 1, 1994, if the property is placed in service (as rehabilitation property) as part of either a rehabilitation completed pursuant to a written contract that was binding (under applicable state law) on March 1, 1986. This rule also applies to a rehabilitation with respect to property (including any leasehold interest) that was acquired before March 2, 1986, or was acquired on or after such date pursuant to a written contract that was binding on March 1, 1986, if (1) parts 1 (if necessary) and 2 of the Historic Preservation Certification Application were filed with the Department of the Interior (or its designee) before March 2, 1986, or (2) the lesser of \$1,000,000 or five percent of the cost of the rehabilitation (including only qualified rehabilitation expenditures) is incurred before March 2, 1986, or is required to be incurred pursuant to a written contract that was binding on March 1, 1986.⁴⁰

If a taxpayer transfers his rights in property under rehabilitation or under a binding contract to another taxpayer, the modifications do not apply to the property in the hands of the transferee, as long as the property was not placed in service before the transfer by the transferor. For purposes of this rule, if by reason of sales or exchanges of interests in a partnership, there is a deemed termination and reconstitution of a partnership under section 708(b)(1)(B), the partnership is to be treated as having transferred its rights in the property under rehabilitation or the binding contract to the new partnership.

If property that qualifies under a transitional rule is placed in service after December 31, 1986, the applicable credit percentages are reduced from 15 to ten, and 20 to 13, respectively. The credit percentage is not reduced for property that qualifies for the 25-percent credit.⁴¹

⁴⁰ A technical correction may be necessary to clarify that—under this rule—the rehabilitation need not be completed pursuant to a written contract that was binding on March 1, 1986.

⁴¹ Similarly, property that qualifies for the 25-percent credit under a transitional rule is not subject to the full basis adjustment requirement. A technical correction may be needed to accomplish this result.

Property that qualifies for transitional relief from the amendments relating to the rehabilitation tax credit is also excepted from the depreciation changes made by section 201 of the Act.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by \$43 million in 1987, \$165 million in 1988, \$581 million in 1989, \$1,371 million in 1990, and \$1,779 million in 1991.

2. Tax credit for low-income rental housing (sec. 252 of the Act and sec. 42 of the Code)¹

Prior Law

No low-income rental housing tax credit was provided under prior law, but other tax incentives for low-income housing were available. These tax incentives consisted principally of special accelerated depreciation, five-year amortization of rehabilitation expenses, expensing of construction period interest and taxes, and tax-exempt bond financing for multifamily residential rental property.

Reasons for Change

Congress was concerned that the tax preferences for low-income rental housing available under prior law were not effective in providing affordable housing for low-income individuals. Congress believed a more efficient mechanism for encouraging the production of low-income rental housing could be provided through the low-income rental housing tax credit.

The primary tax preferences provided for low-income housing under prior law were tax-exempt bond financing, accelerated cost recovery deductions, five-year amortization of rehabilitation expenditures, and special deductions for construction period interest and taxes. These preferences operated in an uncoordinated manner, resulted in subsidies unrelated to the number of low-income individuals served, and failed to guarantee that affordable housing would be provided to the most needy low-income individuals.

A major shortcoming of the prior-law tax subsidies was that, beyond a minimum threshold requirement of low-income housing units that were required to be served, the degree of subsidy was not directly linked to the number of units serving low-income persons. As a result, there was no incentive to provide low-income units beyond the minimum required. Under the tax credit, however, the amount of the low-income housing tax credit which an owner may receive is directly related to the number of rental units made available to low-income individuals. By providing tax credits which are based on the number of units serving low-income persons, an incen-

¹ For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1413; S.Rep. 99-313, pp. 757-768; Senate floor amendment, 132 Cong. Rec. S8146-8158 (June 23, 1986); and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 85-103 (Conference Report).

tive exists to provide a greater number of housing units for more low-income individuals.

Another weakness of the Federal tax subsidies available under prior law was that they were not targeted to persons of truly low-income. For example, a study by the General Accounting Office² (GAO) of tax-exempt bond financed residential rental projects found that above-average income renters could qualify under prior law as "low" or "moderate" income for two reasons. First, persons with incomes as high as 80 percent of area median income were eligible to occupy units reserved for low- and moderate-income tenants. This income ceiling was relatively high, particularly when compared with the median income of renters. Second, the Treasury Department did not require household incomes to be adjusted for family size until after 1985. Congress believed that the low-income housing tax credit (as well as tax-exempt bond financing for low-income housing, discussed in Title XIII) should be provided only for households with incomes not exceeding 50 percent or 60 percent of area median income. Congress further believed that these income limits should be adjusted for family size. These provisions better target affordable housing to those persons most in need of assistance.

Another shortcoming of the tax subsidies under prior law was that none limited the rents that could be charged to low-income individuals. The same GAO study found, for example, that while 96 percent of individuals with incomes over 80 percent of area median income (the prior-law ceiling on "low" or "moderate" income) paid rents of less than 30 percent of their income, only 37 percent of individuals with incomes below 80 percent of area median paid rents of less than 30 percent of their income. The low-income housing tax credit limits the rent that may be charged to a low-income tenant, and therefore ensures that the subsidized housing is affordable to low-income individuals. In return for providing housing at reduced rents, owners of rental housing receive a tax credit designed to compensate them for the rent reduction.

Congress believed that the low-income housing tax credit (and tax-exempt bonds, as retargeted) will more effectively serve both low-income individuals and owners willing to provide affordable low-income housing than the multiple, uncoordinated tax preferences for low-income housing under prior law.

Explanation of Provisions

Overview

The Act provides a tax credit that may be claimed by owners of residential rental property used for low-income housing. The credit is claimed annually, generally for a period of ten years. New construction and rehabilitation expenditures for low-income housing projects placed in service in 1987 are eligible for a maximum nine percent credit, paid annually for ten years. The acquisition cost of existing projects and the cost of newly constructed projects receive

² United States General Accounting Office, *Report to the Chairman, Joint Committee on Taxation, Rental Housing: Costs and Benefits of Financing with Tax-Exempt Bonds* (GAO/RCED-86-2), February 1986.

