

**DESCRIPTION OF
THE HOUSING ASSISTANCE TAX ACT OF 2008**

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By the
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INTRODUCTION

The House Committee on Ways and Means has scheduled a markup on April 9, 2008. This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of the Housing Assistance Tax Act of 2008.

¹ This document may be cited as follows: Joint Committee on Taxation, *Description of the Housing Assistance Tax Act of 2008*, (JCX-27-08), April 8, 2008. This document can also be found on our website at www.house.gov/jct.

I. BENEFITS FOR MULTI-FAMILY LOW-INCOME HOUSING

A. Low-Income Housing Credit

1. Temporary increase in the low-income housing credit volume limits

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.

Description of Proposal

The proposal 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. In 2010 the volume limit will return to the prescribed levels had this proposal not been enacted.

Effective Date

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

2. Determination of credit rate

(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.

Description of Proposal

The proposal expands the class of low-income buildings eligible for the 70-percent credit and provides a floor on the applicable credit percentages for non-Federally subsidized buildings.

The proposal extends the 70-percent credit to non-Federally subsidized existing housing that is substantially rehabilitated (i.e., in the case of an existing building which is substantially rehabilitated, both the qualified basis of the existing building and the qualified rehabilitation expenses are eligible for the 70-percent credit as long as the building is not Federally-subsidized.)

Also, the proposal provides a floor on the applicable percentage for non-Federally subsidized buildings at 9 percent.

Effective Date

The proposal 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.

Description of Proposal

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

Effective Date

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

3. Modifications to definition of eligible basis

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

Present Law

Generally, buildings located in high cost areas (i.e., qualified census tracts and difficult development areas) are eligible for an enhanced credit. Under the enhanced credit, the 70-percent and 30-percent 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.

Description of Proposal

The proposal 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.

Effective Date

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

(b) Modification to the substantial rehabilitation requirement

Present Law

Rehabilitation expenditures² 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.

Description of Proposal

The proposal increases the minimum expenditure requirements. Under the proposal, 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 proposal also indexes the \$6,000 amount for inflation. The other present-law rules apply.⁴

The proposal 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 \$3,000 of rehabilitation expenditures per low-income unit) of the rehabilitation expenditures test is satisfied.

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 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 proposal so that that the \$2,000 amount will be increased to two-thirds of the \$6,000 amount as indexed.

Effective Date

The proposal is effective for buildings placed in service 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.

Description of Proposal

The proposal expands the size of the community service facility with respect to which the low-income housing credit may be claimed. Under the proposal the size of the community service facility may not exceed the sum of: (1) 15 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 \$5,000,000; and (2) 10 percent of any excess over \$5,000,000 of the eligible basis of the qualified low-income housing credit project of which it is a part.

Effective Date

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

(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.

Description of Proposal

The proposal 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 received during the compliance period if those grants do not otherwise increase the taxpayer’s eligible basis in the building.

Effective Date

The proposal 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.

Description of Proposal

The proposal 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 proposal, two persons are related for this purpose if they bear a relationship to each other specified in section 267(b) or 707(b)(1).

Effective Date

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

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.

4. Other simplification and reform of low-income housing tax incentives

(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).

Description of Proposal

The proposal 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 proposal 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.

Description of Proposal

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

(c) Modification 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.

Description of Proposal

The proposal eliminates the bond posting requirement. In its place the proposal 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.

Effective Date

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

Also, at the election of the taxpayer, the proposal 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.

(d) 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

⁷ See also the discussion of the full-time student rule in item I.B.2., above.

assistance under the Job Training Partnership Act or under other similar Federal, State, or local laws.

Description of Proposal

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

(e) Additions 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.

Description of Proposal

The proposal 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.

Effective Date

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

B. Modifications to Tax-Exempt Housing Bond Rules

1. Refunding treatment for certain multifamily housing bonds

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.⁸

Description of Proposal

Under the proposal, if within 6 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

⁸ Sec. 147(b).

bond financing the original conduit loan) shall be treated as a refunding issue. Thus, under the proposal, the refinancing bond is treated as a refunding notwithstanding a change in obligors under the first and second conduit loans. The proposal 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 proposal applies to repayments of loans received after the date of enactment.

2. Coordination of certain rules applicable to the low-income housing credit and qualified residential rental project exempt facility bonds

Next available unit rules

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 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”).⁹

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.¹⁰ 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.

Description of Proposal

In the case of a low-income building which is tax-exempt bond financed and eligible for the low-income housing credit, the proposal 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.

⁹ Sec. 42(g)(2)(D)(ii).

¹⁰ Sec. 142(d)(3)(B).

Effective Date

The proposal 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.

Students

Present Law

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 unless those students are comprised entirely of single parents and their children. 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 this purpose tax exempt bonds are slightly different full this student rule applies.

Description of Proposal

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

Effective Date

The proposal 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.

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.¹¹

¹¹ Treas. Reg. 1.103-8(b)(10)(ii).

Description of Proposal

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

Effective Date

The proposal 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. Reforms Related to the Low-Income Housing Credit and Tax-Exempt Housing Bonds

1. Hold harmless for reductions in area median gross income

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 determination 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.

Description of Proposal

In general

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

Determination of income and area median gross income

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

2. Exception from the annual recertification requirement for projects which are entirely low-income use

Present Law

Tax Code 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 income 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.

Description of Proposal

The proposal 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 proposal does not modify the HUD rules; therefore some projects must continue annual certification notwithstanding this proposal.

Effective Date

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

II. BENEFITS FOR SINGLE FAMILY HOUSING

A. First-Time Homebuyer Credit

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.

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 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, 2007.¹²

Description of Proposal

Under the proposal, a taxpayer who is a first-time homebuyer is allowed a refundable tax credit equal to the lesser of \$7,500 or 10 percent of the purchase price of a principal residence. The \$7,500 maximum credit applies both to individuals and married couples filing a joint return. A married individual filing separately can claim a maximum credit of \$3,750. 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 \$70,000 and \$90,000 (\$110,000-\$130,000 for joint filers) for the year of purchase.

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.

¹² 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.

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.

Effective Date

The provision is effective for qualifying home purchases after the date of committee action and before April 1, 2009 (without regard to whether or not there was a binding contract to purchase prior to the date of committee action).

**B. Additional Standard Deduction for State and
Local Property Taxes for Non-Itemizers**

Present Law

For purposes of determining regular tax liability, an itemized deduction is permitted for certain State and local taxes paid, including individual income taxes, real property taxes, and personal property taxes.

Description of Proposal

The provision allows taxpayers an additional standard deduction for State and local real property taxes for taxpayers who claim the regular standard deduction. The additional standard deduction applies only for 2008, and is limited to \$350 (\$700 in the case of a married individual filing jointly).

Effective Date

The provision applies to taxable years beginning in 2008.

III. GENERAL HOUSING PROVISIONS

A. Modifications to Qualified Private Activity Bond Rules for Housing

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 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”).

Description of Proposal

Temporary volume cap increase

The proposal authorizes an additional \$10 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 population of such State bears to the population of all 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 proposal 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 proposal 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 proposal, 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 proposal also provides that qualified subprime loans cannot be refinanced by bonds issued after December 31, 2010.

Effective Date

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

B. Repeal of Alternative Minimum Tax Limitation on Low-Income Housing Credit and Rehabilitation Credit

Present Law

Under present law, 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.¹³

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

The tentative minimum tax is an amount equal to specified rates of tax imposed on the excess of the alternative minimum taxable income over an exemption amount. To the extent the tentative minimum tax exceeds the regular tax, a taxpayer is subject to the alternative minimum tax.

Description of Proposal

The proposal 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 rehabilitation credit may offset the alternative minimum tax liability.

Effective Date

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

The proposal 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 these credits).

¹³ 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.

C. Alternative Minimum Tax Treatment of Interest on Certain Bonds

Present Law

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. 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)).

Description of Proposal

The proposal 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 proposal 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.

Effective Date

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

D. Bonds Guaranteed by Federal Home Loan Banks Eligible for Treatment as Tax-Exempt Bonds

Present Law

Interest 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.

Description of Proposal

Under the proposal, 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.

Effective Date

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

E. Modification of Rules Pertaining to FIRPTA Nonforeign Affidavits

Present Law

In general, nonresident aliens and foreign corporations are not taxed on capital gains.¹⁴ 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.¹⁵

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.¹⁶ 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 requirement that the transferee furnish a copy of such affidavit to the Secretary.¹⁷ 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.¹⁸

¹⁴ 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).

¹⁵ Sec. 897(a)(1).

¹⁶ Sec. 1445(a).

¹⁷ Sec. 1445(b).

¹⁸ Treas. Reg. sec. 1.1445-2(b)(3).

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.¹⁹ 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.²⁰ However, an agent's liability under these circumstances is limited to the amount of the agent's compensation from the transaction.²¹

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.²² 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.²³

Description of Proposal

The proposal 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.

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

¹⁹ Sec. 1445(d)(1).

²⁰ Sec. 1445(d)(2)(A).

²¹ Sec. 1445(d)(2)(B).

²² 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).

²³ 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).

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 proposal. 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 proposal is effective for dispositions after the date of enactment.

F. Modify Rehabilitation Credit Tax-Exempt Use Safe Harbor

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 (e.g., if the lease term exceeds 20 years or other criteria are present) to tax-exempt entities, including the United States or a State or an agency or instrumentality thereof, a tax-exempt organization, a foreign person or entity, or an Indian tribal government. However, 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.

Description of Proposal

The proposal increases the percentage from 35 percent to 50 percent, so that 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.

Effective Date

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

IV. REAL ESTATE INVESTMENT TRUST (“REIT”) MODIFICATIONS

Present Law

In general

A real estate investment trust (“REIT”) is an entity that otherwise would be taxed as a U.S. corporation, that elects to be taxed under a special REIT tax regime, and that meets specified requirements. At least 90 percent of REIT income (other than net capital gain) must be distributed annually; the REIT must derive most of its income from passive, generally real estate-related investments; and REIT assets must be primarily real estate related. Other requirements also apply.²⁴

If an electing entity meets the requirements for REIT status, the portion of its income that is distributed to its investors each year as a dividend is deductible by the REIT (unlike the case of a regular corporation that cannot deduct dividends). As a result, the distributed income of the REIT is not taxed at the entity level; the distributed income is taxed only at the investor level.²⁵

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 a taxable year must consist of real estate related income. This 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”).²⁶

In addition, 95 percent of the REIT gross income in a taxable year must be from the 75-percent required sources, plus other generally passive investments such as dividends, capital gains, and interest income (the “95-percent income test”).²⁷ Amounts attributable to most types

²⁴ Secs. 856 and 857. Among other requirements, a REIT must have transferable interests, must have at least 100 shareholders, and more than 50 percent of the REIT interests may not be owned by 5 or fewer individual shareholders (as determined using specified attribution rules).

²⁵ A REIT that has net capital gain can either distribute that gain as a “capital gain” dividend or retain that gain without distributing it. A mechanism is provided under which the shareholders can report the net capital gain as if it were distributed to them. In either case, the gain is in effect taxed only as net capital gain of the shareholders. Sec. 857(b)(3).

²⁶ Secs. 856(c)(3) and 1221(a)(1). Income from sales that are not prohibited transactions solely by virtue of section 857(b)(6) is also qualified REIT income.

²⁷ Sec. 856(c)(3).

of services provided to tenants (other than certain “customary services”), or to more than specified amounts of personal property, are not qualifying rents.²⁸ In addition, amounts received from any entity in which the REIT owns more than 10 percent of the vote or value also generally are not qualifying income, though there is an exception for certain amounts received from taxable REIT subsidiaries (described further below).

Except as provided by regulations, income from a hedging transaction which is clearly identified,²⁹ including gain from the sale or disposition of such a transaction, is not included as gross income under the 95 percent of 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.³⁰

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.³¹ A REIT that holds foreign real estate or other foreign based assets may experience 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 some 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. Section 985 provides in general that all determinations for Federal income tax purposes are made in the taxpayer’s functional currency. 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.”³² A QBU is any separate and clearly identified unit of a trade or business of a taxpayer that maintains separate books and records.³³

²⁸ 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).

²⁹ A hedging transaction for this purpose is one defined in clause (i) or (ii) of section 1221(b)(2)(A). The identification requirement is defined in section 1221(a)(7).

³⁰ Sec. 856(c)(5)(G).

³¹ See Rev. Rul. 74-191, 1974-1 C.B. 170.

³² Sec. 985(b)(1).

³³ Sec. 989(a).

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.³⁴

When a REIT holds a mortgage (or other instrument or arrangement described in section 988)³⁵ denominated in foreign currency, the REIT may experience foreign currency gain or loss under the rules of section 988 if 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. In May 2007, the IRS ruled in Rev. Rul. 2007-33 that section 988 currency gain that is recognized by a REIT will be qualifying income for purposes of the 95-percent and 75-percent income tests of section 856(c)(2) and (3), respectively, to the extent the underlying income so qualifies.³⁶

Section 987 applies when there is a remittance from a foreign 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 were to operate with a QBU that kept its books and records in a foreign currency, the REIT could experience foreign currency exchange gain or loss on remittances under these rules.³⁷

³⁴ Sec. 988(c)(1)(B) and (C).

³⁵ 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.

³⁶ Rev. Rul. 2007-33, 2007-21 I.R.B. 1281. This ruling does not specifically address the treatment of currency gain that might arise with respect to the payment of principal, nor does it specifically address the treatment of foreign currency gain that might arise in connection with a borrowing in a foreign currency made 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 qualifying assets would be treated as qualifying income. PLR 200808024. A private letter ruling may be relied upon only by the taxpayer to which the ruling is issued.

³⁷ 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, 2007-21 I.R.B. 1288, *infra*.

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 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.³⁸ While this structure provides a method of doing business abroad, this structure effectively requires a separate REIT subsidiary for each different currency in which the REIT may conduct activities.³⁹

In 2007 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).⁴⁰

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.⁴¹

Asset tests

At least 75 percent of the value of REIT 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

³⁸ 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.

³⁹ In this structure, the parent REIT treats the dividends paid by the subsidiary REIT as a qualified REIT dividend, and minimizes any currency gains by having the subsidiary convert the foreign currency into dollars at the same time as the dividend distribution by the subsidiary.

⁴⁰ Notice 2007-42, 2007-21 I.R.B. 1288. Compare REG-208270-86 (Sept. 7, 2006), which by its terms did not apply to REITs.

⁴¹ PLR 200039027 and PLR 200127024. A private letter ruling may be relied upon only by the taxpayer to which the ruling was issued.

property) and shares (or transferable certificates of beneficial interest) in other REITs.⁴² No more than 25 percent of REIT assets may be securities other than such real estate assets.⁴³

Except with respect to a taxable REIT subsidiary (described further below), not more than 5 percent of the value of REIT 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.⁴⁴ In addition, not more than 20 percent of the value of a REIT's assets may be securities of one or more taxable REIT subsidiaries.⁴⁵

The asset tests must be met as of the close of each quarter. 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 such investments and such requirements, unless there is an acquisition of one or more investments to which the change in value is attributable.⁴⁶

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 TRS's do not represent more than 20 percent 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.⁴⁷ Furthermore, rent paid to the REIT by the TRS in such a case 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, unless,

⁴² Sec. 856(c)(4)(A). Certain stock or debt instruments that are temporary investments also qualify if they are temporary investments of new capital, but only for the 1-year period beginning on the date the REIT receives such capital. Sec. 856(c)(5)(B).

⁴³ Sec. 856(c)(4)(B)(i).

⁴⁴ Sec. 856(c)(4)(B)(iii).

⁴⁵ Sec. 856(c)(4)(B)(ii).

⁴⁶ 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.

⁴⁷ 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. 857(d)(9)(B).

in the case of a TRS, at least 90 percent of the space is rented to unrelated parties and the rent paid by the TRS is comparable to the rent paid by the unrelated parties.⁴⁸

Prohibited transactions tax

REITs are subject to a prohibited transaction tax (“PTT”) of 100 percent of the net income derived from prohibited transactions. The definition of a prohibited transaction for this purpose is the same as the definition of a transaction the gain on which for any taxpayer (not limited to a REIT) would otherwise be ordinary income, rather than capital gain, because it 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)). The PTT for a REIT does not apply if the sale satisfies certain safe harbor provisions in sections 857(b)(6)(C) or (D), including an asset holding period of at least four years.⁴⁹ If the conditions are met, the REIT can sell up to 10 percent of the aggregate bases of all its assets as of the beginning of the taxable year, without being subject to the PTT tax.

Description of Proposal

Foreign currency gain

The proposal would include certain foreign currency gains under sections 987 or 988 as qualifying income for purposes of the 75-percent and 95-percent income tests. In the case of a section 988 transaction, foreign currency gain that is “attributable to” income items that otherwise are treated as qualifying income for purposes of the 75-percent and 95-percent income tests, respectively (and including any other 988 gain attributable to the acquisition or ownership of, or to becoming the obligor under, obligations secured by mortgages on real property or on interests in real property), would be treated as qualifying income for those tests.⁵⁰ The proposal would reach a result similar to that in Rev. Rul. 2007-33 in the case of gain attributable to an item of REIT income, and would in addition clarify that there is a similar result in the case of currency gain associated with principal payments and with certain liabilities of a REIT.

⁴⁸ 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.

⁴⁹ Additional requirements for the safe harbor limit the amount of expenditures the REIT can make during the 4-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.

⁵⁰ It is intended that in the case of a section 988 transaction, any currency gain arising after the payment of a section 988 item would not be treated as “attributable to” qualifying income under this proposal and, thus, would not be treated as qualifying income.

In the case of QBU with a functional currency other than the U.S. dollar, section 987 foreign currency gain would be treated as qualifying income for purposes of both the 75- percent and 95-percent income tests if such gain is attributable to a QBU that independently meets the 75-percent income and asset tests (before application of the provision). Consequently, a REIT could establish under the bill a branch QBU rather than using a subsidiary REIT structure.⁵¹ The proposal thus would allow currency gain on remittances to qualify as good REIT income without requiring for that purpose the particular tracing-type rules of the existing section 987 proposed regulations as allowed for REITs under Notice 2007-42. The QBU itself would not have to meet the 95-percent income test in order for currency gain on its remittances to be treated as qualified income. The REIT still would be required to meet the 95-percent income test, as well as all the other REIT requirements, on an overall basis that includes the income and assets of its QBU. However, for this purpose, any currency gains on remittances from a QBU that met the 75 percent income and asset tests would be added to qualifying income for purposes of both the 75-percent and 95-percent income tests.

In addition, any other foreign currency gain may, if so determined by the Secretary of the Treasury, be considered qualified income.

The proposal makes several changes to other REIT provisions, so that they also refer to foreign currency gains or losses. First, the present law rule that excludes certain hedging income from the computation of the 95-percent income test would be extended to exclude income from the hedging of currency for purposes of the 75-percent or 95-percent tests, respectively, where the currency gain, if any, would be good income under the provision for such 75-percent or 95-percent income tests, respectively. Second, 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 modified to include a discrepancy caused solely by the change in the foreign currency exchange rate used to value a foreign asset. Third, the term “cash” for purposes of the REIT asset qualification rules would include foreign currency if the REIT or its QBU uses such currency as its functional currency. Fourth, permitted foreclosure property income also would include foreign currency gain that is attributable to otherwise permitted income from foreclosure property. Finally, foreign currency gain under section 988(b)(1), or loss under section 988(b)(2), that is attributable to any prohibited transaction would be 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 proposal would authorize the Treasury Department to issue guidance that would allow other items of income to be qualifying income (or to be excluded from the computation altogether).

⁵¹ In the case of a QBU that meets those tests, it is intended that although section 987 foreign currency gain on remittances as of the time of remittance would be considered attributable to the QBU and would be considered qualifying income, currency gain arising after remittance would not be attributable to the QBU and would not be treated as qualifying income under the proposal.

Taxable REIT subsidiary limit increase

The proposal would increase 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.

Holding period under safe harbor for prohibited transactions

The proposal would shorten from four years to two years the minimum holding period under the prohibited transactions tax safe harbor. The provision would make 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. Consequently, capital gain treatment would continue to be determined based on all the facts and circumstances as under present law, without regard to the prohibited transactions tax safe harbor.

Permitted extent of sales under safe harbor for prohibited transactions

The proposal changes the maximum amount of sales within a taxable year that can qualify for the prohibited transactions tax safe harbor. Instead of the present 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 proposal is 10 percent of either such basis or 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 proposal 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 would be 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 would be qualifying rental income for purposes of the 75-percent and 95-percent income tests. Under the proposal, a taxable REIT subsidiary would not 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 possessed a license, permit, or similar instrument enabling it to do so.

Effective Date

The provisions of the proposal generally would be effective for taxable years beginning after the date of enactment. However, the rules treating certain foreign currency gain as qualified income for purposes of the income tests would apply to gains and items of income recognized after the date of enactment. The hedging rules relating to the new foreign currency rules would be effective for transactions entered into after such date of enactment. The Treasury authority to treat additional items of income as qualified income or to exclude such items from income for purposes of the income qualification tests would apply after the date of enactment. The foreign currency conforming amendment relating to gain from foreclosure property would apply to gains recognized after the date of enactment, and the provision relating to net prohibited transactions income would apply to gains and deductions recognized after the date of enactment.

The provisions relating to the prohibited transactions tax safe harbor would apply to sales made after the date of enactment.

V. REVENUE PROVISIONS

A. Broker Reporting of Customer's Basis in Securities Transactions

Present Law

In general

Gain or loss generally is recognized for Federal income tax purposes on realization of that gain or loss (for example, through the sale of property giving rise to the gain or loss). The taxpayer's gain or loss on a disposition of property is the difference between the amount realized and the adjusted basis.⁵²

To compute adjusted basis, a taxpayer must first determine the property's unadjusted or original basis and then make adjustments prescribed by the Code.⁵³ The original basis of property is its cost, except as otherwise prescribed by the Code (for example, in the case of property acquired by gift or bequest or in a tax-free exchange). Once determined, the taxpayer's original basis generally is adjusted downward to take account of depreciation or amortization, and generally is adjusted upward to reflect income and gain inclusions or capital outlays with respect to the property.

Basis computation rules

If a taxpayer has acquired stock in a corporation on different dates or at different prices and sells or transfers some of the shares of that stock, and the lot from which the stock is sold or transferred is not adequately identified, the shares deemed sold are the earliest acquired shares (the "first-in-first-out rule").⁵⁴ If a taxpayer makes an adequate identification of shares of stock that it sells, the shares of stock treated as sold are the shares that have been identified.⁵⁵ A taxpayer who owns shares in a regulated investment company ("RIC") generally is permitted to elect, in lieu of the specific identification or first-in-first-out methods, to determine the basis of RIC shares sold under one of two average-cost-basis methods described in Treasury regulations.⁵⁶

⁵² Sec. 1001.

⁵³ Sec. 1016.

⁵⁴ Treas. Reg. sec. 1.1012-1(c)(1).

⁵⁵ Treas. Reg. sec. 1.1012-1(c).

⁵⁶ Treas. Reg. sec. 1.1012-1(e).

Information reporting

Present law imposes information reporting requirements on participants in certain transactions. Under these requirements, information is generally reported to the IRS and furnished to taxpayers. These requirements are intended to assist taxpayers in preparing their income tax returns and to help the IRS determine whether taxpayers' tax 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.⁵⁷

Section 6045(a) requires brokers to file with the IRS annual information returns showing the gross proceeds realized by customers from various sale transactions. The Secretary is authorized to require brokers to report additional information related to customers.⁵⁸ Brokers are required to furnish to every customer information statements with the same gross proceeds information that is included in the returns filed with the IRS for that customer.⁵⁹ These information statements are required to be furnished by January 31 of the year following the calendar year for which the return under section 6045(a) is required to be filed.⁶⁰

A person who is required to file information returns but who fails to do so by the due date for the returns, includes on the returns incorrect information, or files incomplete returns generally is subject to a penalty of \$50 for each return with respect to which such a failure occurs, up to a maximum of \$250,000 in any calendar year.⁶¹ Similar penalties, with a \$100,000 calendar year maximum, apply to failures to furnish correct information statements to recipients of payments for which information reporting is required.⁶²

Present law does not require information reporting with respect to a taxpayer's basis in property but does impose an obligation to keep records, as described below.

Basis recordkeeping requirements

Taxpayers are required to "keep such records . . . as the Secretary may from time to time prescribe."⁶³ Treasury regulations impose recordkeeping requirements on any person required to file information returns.⁶⁴

⁵⁷ Sec. 6041(a).

⁵⁸ Sec. 6045(a).

⁵⁹ Sec. 6045(b).

⁶⁰ Id.

⁶¹ Sec. 6721.

⁶² Sec. 6722.

⁶³ Sec. 6001.

Treasury regulations provide that donors and donees should keep records that are relevant in determining a donee's basis in property.⁶⁵ IRS Publication 552 states that a taxpayer should keep basis records for property until the period of limitations expires for the year in which the taxpayer disposes of the property.

Explanation of Provision

In general

Under the provision, every broker that is required to file a return under section 6045(a) reporting the gross proceeds from the sale of a covered security must include in the return the (1) customer's adjusted basis in the security and (2) whether any gain or loss with respect to the security is long-term or short-term (within the meaning of section 1222).

Covered securities

A covered security is any specified security acquired on or after an applicable date if the security was (1) acquired through a transaction in the account in which the security is held or (2) was transferred to that account from an account in which the security was a covered security, but only if the transferee broker received a statement under section 6045A (described below) with respect to the transfer. Under this rule, securities acquired by gift or inheritance are not covered securities.

A specified security is any share of stock in a corporation (including stock of a regulated investment company); any note, bond, debenture, or other evidence of indebtedness; any commodity or a contract or a derivative with respect to the commodity if the Secretary determines that adjusted basis reporting is appropriate; and any other financial instrument with respect to which the Secretary determines that adjusted basis reporting is appropriate.

For stock in a corporation (including in a regulated investment company), the applicable date generally is January 1, 2010. Open-end funds (defined below) are permitted to elect to treat as a covered security any stock in the fund acquired before January 1, 2010. This election is described below.

For any specified security other than stock in a corporation, the applicable date is January 1, 2012, or a later date determined by the Secretary.

Computation of adjusted basis

The customer's adjusted basis required to be reported to the IRS is determined under the following rules. The adjusted basis of any security other than stock for which an average basis method is permissible under section 1012 is determined under this first-in, first-out method

⁶⁴ Treas. Reg. sec. 1.6001-1(a).

⁶⁵ Treas. Reg. sec. 1.1015-1(g).

unless the customer notifies the broker by means of making an adequate identification (under the rules of section 1012 for specific identification) of the stock sold or transferred. The adjusted basis of stock for which an average basis method is permissible under section 1012 and that is acquired before January 1, 2012 is determined in accordance with any acceptable method under section 1012 (that is, the first-in, first-out method, the average cost method, or the specific identification method). Under this rule, a broker's basis computation method used for stock held in one account with that broker may differ from the basis computation method used for stock held in another account with that broker. The adjusted basis of stock for which an average basis method is permissible under section 1012 and that is acquired on or after January 1, 2012 is determined in accordance with the broker's default method (that is, a method that is permitted by section 1012 and that is generally used by the broker in tracking basis) unless the customer notifies the broker that the customer elects another method permitted by section 1012. This notification is made separately for each account in which stock is held and, once made, applies to all open-end stock held in the account.

For any sale, exchange, or other disposition of a specified security after the applicable date (defined previously), the provision modifies section 1012 so that the conventions prescribed by regulations under that section for determining adjusted basis (the first-in, first-out, specific identification, and average cost conventions) apply on an account-by-account basis. Under this rule, for example, if a customer holds shares of the same specified security in accounts with different brokers, each broker makes its adjusted basis determinations by reference only to the shares held in the account with that broker. Unless the election described next applies, stock in an open-end fund acquired before January 1, 2010 is treated as a separate account. A consequence of this rule is that if adjusted basis is being determined using the average cost convention, average cost is computed without regard to any open-end stock acquired before January 1, 2010. An open-end fund, however, may elect (at the time and in the form and manner prescribed by the Secretary), on a stockholder-by-stockholder basis, to treat as covered securities all stock in the fund held by the stockholder without regard to when the stock was acquired. When this election applies, the average cost of a customer's open-end stock is determined by taking into account shares of stock acquired before, on, and after January 1, 2010. A similar election is allowed for any broker holding stock in an open-end fund as a nominee of the beneficial owner of the stock.

An open-end fund is a regulated investment company (as defined in section 851) that offers for sale or has outstanding any redeemable security of which it is the issuer and the shares of which are not traded on an established securities exchange. A mutual fund the stock of which is priced daily and is acquired from the fund is an open-end fund. So-called exchange traded funds, funds in which there is intra-day pricing and in which shares may be purchased on an exchange (rather than from the funds directly) are not open-end funds. It is intended that if a regulated investment company offers two or more classes of shares one or more of which is traded on an established securities exchange and one or more of which is not traded on such an exchange, the regulated investment company will be treated as an open-end fund with respect to the class or classes of shares that are not traded on an established securities exchange.

If stock is acquired on or after January 1, 2010 in connection with a dividend reinvestment plan, the basis of that stock is determined under one of the basis computation methods permissible for stock in an open-end fund. Accordingly, the average cost method may

be used for determining the basis of this stock. In determining basis under this rule, the account-by-account rules described previously, including the election available to open-end funds, apply. A dividend reinvestment plan means any arrangement under which dividends on stock are reinvested in stock identical to the stock with respect to which the dividends are paid. Stock is treated as acquired in connection with such a plan if the stock is acquired pursuant to the plan or if the dividends paid on the stock are subject to the plan.

Exception for wash sales

Unless the Secretary provides otherwise, a customer's adjusted basis in a covered security generally is determined without taking into account the effect on basis of the wash sale rules of section 1091. If, however, the acquisition and sale transactions resulting in a wash sale under section 1091 occur in the same account and are in identical securities, adjusted basis is determined by taking into account the effect of the wash sale rules. Securities are identical for this purpose only if they have the same Committee on Uniform Security Identification Procedures number.

Special rules for short sales

The provision provides that in the case of a short sale, gross proceeds and basis reporting under section 6045 generally is required in the year in which the short sale is closed (rather than, as under the present law rule for gross proceeds reporting, the year in which the short sale is entered into). This rule does not, however, apply to any short sale that results in a constructive sale under section 1259 with respect to property held in the account in which the short sale is entered into. As a result of this rule, gross proceeds and basis reporting for a constructive sale is required in the year in which the short sale resulting in the constructive sale is entered into so long as the short sale is made in the account in which the taxpayer holds the relevant property.

Reporting requirements for options

The provision generally eliminates the present-law regulatory exception from section 6045(a) reporting for certain options. If a covered security is acquired by the exercise of an option, or is delivered to satisfy the exercise of an option, and the option was granted or acquired in the same account as the covered security, the amount of the premium received or paid for the option is treated as an adjustment to the gross proceeds from the subsequent sale of the covered security or as an adjustment to the customer's adjusted basis in that security. Gross proceeds and basis reporting also generally is required when there is a lapse of, or a closing transaction with respect to, an option on a specified security. These reporting rules related to options transactions apply only to options granted or acquired on or after January 1, 2012.

Treatment of S corporations

The provision provides that for purposes of section 6045, an S corporation (other than a financial institution) is treated in the same manner as a partnership. This rule applies to any sale of a covered security acquired by an S corporation (other than a financial institution) after December 31, 2011. When this rule takes effect, brokers generally will be required to report gross proceeds and basis information to customers that are S corporations.

Time for providing statements to customers

The provision changes to February 15 the present-law January 31 deadline for furnishing certain information statements to customers. The statements to which the new February 15 deadline applies are (1) statements showing gross proceeds (under section 6045(b)) or substitute payments (under section 6045(d)) and (2) consolidated reporting statements (as defined in regulations) for reporting gross proceeds, dividends (under section 6042(c)), interest (under section 6049(c)(2)(A)), or royalties (under section 6050N(b)). The term “consolidated reporting statement” is intended to refer to annual tax information statements that brokerage firms customarily provide to their customers.

Broker-to-broker and issuer reporting

Every broker (as defined in section 6045(c)(1)), and any other person specified in Treasury regulations, that transfers to a broker (as defined in section 6045(c)(1)) a security that is a covered security when held by that broker or other person must, under new section 6045A, furnish to the transferee broker a written statement that allows the transferee broker to satisfy the provision’s basis and holding period reporting requirements. The Secretary may provide regulations that prescribe the content of this statement and the manner in which it must be furnished. It is contemplated that the Secretary will permit this broker-to-broker reporting requirement to be satisfied electronically rather than by paper. Unless the Secretary provides otherwise, the statement required by this rule must be furnished on the date of the transfer of the covered security.

Present law penalties for failure to furnish correct payee statements apply to failures to furnish correct statements in connection with the transfer of covered securities.

New section 6045B requires, according to forms or regulations prescribed by the Secretary, any issuer of a specified security to file a return setting forth a description of any organizational action (such as a stock split or a merger or acquisition) that affects the basis of the specified security, the quantitative effect on the basis of that specified security, and any other information required by the Secretary. This return must be filed within 45 days after the date of the organizational action or, if earlier, by January 15 of the year following the calendar year during which the action occurred. Every person required to file this return for a specified security also must furnish, according to forms or regulations prescribed by the Secretary, to the nominee with respect to that security (or to a certificate holder if there is no nominee) a written statement showing the name, address, and phone number of the information contact of the person required to file the return, the information required to be included on the return with respect to the security, and any other information required by the Secretary. This statement must be furnished to the nominee or certificate holder on or before January 15 of the year following the calendar year in which the organizational action took place. No return or information statement is required to be provided under new section 6045B for any action with respect to a specified security if the action occurs before the applicable date (as defined previously) for that security.

The Secretary may waive the return filing and information statement requirements if the person to which the requirements apply makes publicly available, in the form and manner determined by the Secretary, the name, address, phone number, and email address of the

information contact of that person, and the information about the organizational action and its effect on basis otherwise required to be included in the return.

The present-law penalties for failure to file correct information returns apply to failures to file correct returns in connection with organizational actions. Similarly, the present-law penalties for failure to furnish correct payee statements apply to a failure under new section 6045B to furnish correct statements to nominees or holders or to provide required publicly-available information in lieu of returns and written statements.

Effective Date

The provision generally takes effect on January 1, 2010. The change to February 15 of the present-law January 31 deadline for furnishing certain information statements to customers applies to statements required to be furnished after December 31, 2008.

B. Delay Implementation of Worldwide Interest Allocation

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.⁶⁶ 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.

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.⁶⁷ 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

⁶⁶ However, exceptions to the fungibility principle are provided in particular cases, some of which are described below.

⁶⁷ One such exception is that the affiliated group for interest allocation purposes includes section 936 corporations that are excluded from the consolidated group.

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”)⁶⁸ 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 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,⁶⁹ 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

⁶⁸ Pub. L. No. 108-357, sec. 401 (2004).

⁶⁹ 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.

principles of worldwide interest allocation were applied separately to the foreign members of the group.⁷⁰

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,⁷¹ 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.

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 provides 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.⁷² For these purposes, items of income or gain from a transaction or series of

⁷⁰ 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.

⁷¹ 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.

⁷² See Treas. Reg. sec. 1.904-4(e)(2).

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.

Description of Proposal

The proposal delays the effective date of worldwide interest allocation rules for one year, until taxable years beginning after December 31, 2009. The required dates for making the worldwide affiliated group election and the financial institution group election are changed accordingly.

The proposal 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 10 percent of the excess of (i) the amount of its taxable income from foreign sources as calculated using the worldwide interest allocation 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 proposal is effective on the date of enactment.

C. Modifications to Corporate Estimated Tax Payments

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.

Description of Proposal

The proposal 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, the otherwise applicable payment are increased by 13 percent 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 proposal is effective on the date of enactment.