

**Impact of H.R. 3221: The Housing and Economic Recovery Act of 2008
on Individual Rehabilitation Tax Credit Investors
(Making Small Rehabilitation Tax Credit Deals Work)**

Executive Summary

The federal historic tax credit has been difficult to use on small Main Street-scale rehabilitation projects because the transaction costs are high and investor interest in these “mom and pop” deals has been very low. Recent federal legislation provides a simpler, less costly approach to attracting investor equity to these projects without the need to involve out-of-town lawyers, accountants and investors.

Now local developers who intend to rehabilitate small buildings generating small amounts of credits, and who qualify as “real estate professionals” under IRS regulations, can take the credits themselves and use the credits to lower their Alternative Minimum Tax (AMT). Developers or property owners who do not qualify as real estate professionals can work with their local accountant to identify an individual who is both a real estate professional and subject to AMT. Through the formation of a limited partnership or limited liability company, this investor can be made a transaction partner for purposes of paying the property owner cash in exchange for the right to use the credits.

Background/Overview of H.R. 3221

The Housing and Economic Recovery Act of 2008 (HR 3221), designed primarily to address the subprime mortgage crisis, was passed by the United States Congress on July 24, 2008 and signed by President George W. Bush on July 30, 2008. The rescue package was aimed at resurrecting the housing market from its worst slump since the Great Depression, and to stabilize and restore confidence in the two largest mortgage finance companies, Fannie Mae and Freddie Mac, by strengthening regulations and injecting capital into these two large U.S. suppliers of mortgage funding. The new law launches a \$300 billion government initiative to refinance troubled mortgages and boosts oversight of Fannie Mae and Freddie Mac, which own or guarantee almost half the country's \$12 trillion in home mortgage debt. One of the highlights of the new law is to eliminate restrictions imposed on certain tax credit programs by the alternative minimum tax.

Effects of H.R. 3221 on Rehabilitation Tax Credits

Historically, small rehabilitation tax credit projects have not been attractive investments for institutional investors. As such, Main Street-scale developers often have difficulty acquiring proper financing for small rehabilitation tax credit projects. Banks and other large institutions have rejected these investments due to the fact that the potential rehabilitation tax credits generated were small and not considered worth the effort. High transaction costs compared to the benefits have also been a disincentive for developers and property owners. Prior to the tax reforms of 1986, small rehabilitation tax credit projects were an ideal investment opportunity for individual investors.

Unfortunately, the passive loss limitations enacted in 1986 combined with the AMT created limitations on high net worth individual investors and deterred potential investors from partaking in the rehabilitation tax credit program. Prior to HR 3221, rehabilitation tax credits could not be claimed against the AMT, but were only allowed to offset a taxpayer's regular tax liability. As a result, even relatively small credit amounts often needed to be carried forward, limiting the incentive effect of these

tax credits for individual investors. The passage of the bill H.R. 3221 now allows some tax credits such as the rehabilitation tax credit to be used to offset the AMT.

Under Section 3022 of H.R. 3221 “Repeal of Alternative Minimum Tax Limitations on Tax-Exempt Housing Bonds, Low-Income Housing Tax Credit, and Rehabilitation Credit (RTC),” the rehabilitation tax credit determined under section 47 of the Internal Revenue Code (IRC) to the extent attributable to qualified rehabilitation expenditures properly taken into account for periods after December 31, 2007, is now allowed to be an offset against AMT.

The following example illustrates the effects on an individual taxpayer’s tax liability prior to and after the passing of the new tax law.

Facts:		
<ul style="list-style-type: none"> • <u>Project Information</u> <ul style="list-style-type: none"> <i>Uses</i> <ul style="list-style-type: none"> ○ Acquisition: \$100,000 ○ Renovation Costs: \$1,600,000 <i>Sources</i> <ul style="list-style-type: none"> ○ Owner Equity: \$100,000 ○ Rehabilitation Tax Credit Equity: \$275,000 ○ State Rehabilitation Tax Credit Equity: \$192,000 ○ Construction/Permanent Loan: \$550,000 ○ National Trust Loan: \$583,000 • <u>Individual Investor Information</u> <ul style="list-style-type: none"> ○ Regular Taxable Income: \$1,000,000 ○ Filing Status: Single ○ AMT Adjustment*: +\$80,000 ○ AMT Preference**: +\$10,000 ○ AMT Exemption (<i>for single taxpayers</i>)***: \$33,750 less 25% (AMTI-\$112,500) ○ Regular Tax Computation for Taxable Income over \$357,700 (<i>for single taxpayers</i>): \$103,792 plus 35% of the excess over \$357,700 ○ Tentative Minimum Tax Computation for Taxable Income over \$175,000 (<i>for single taxpayers</i>): \$45,500 plus 28% of the excess over \$175,000 ○ Rehabilitation Tax Credits (<i>available to claim</i>): \$275,000 <p>* AMT Adjustments include: passive activity losses, accelerated depreciation (post 1986 purchases), net operating loss, installment income of a dealer, contracts (percentage completion vs. completed contract), tax deductions, interest deductions on some home equity loans, medical deductions (limited to excess over 10% AGI), miscellaneous deductions not allowed, and exemptions (personal) and standard deduction.</p> <p>** AMT Preferences include: private activity bond interest income, percentage depletion the excess over adjusted basis of property, and pre-1987 accelerated depreciation.</p> <p>*** AMT Exemption is the allowable exemption amount that can be deducted when calculating the alternative minimum taxable income.</p>		

AMT Calculation	Prior to H.R. 3221	After H.R. 3221
Regular Taxable Income	\$1,000,000	\$1,000,000
+/- Adjustments	+80,000	+80,000
+ Preferences	<u>10,000</u>	<u>10,000</u>
Alternative Minimum Taxable Income (AMTI)	1,090,000	1,090,000
<Exemption>	<u>0</u>	<u>0</u>
Alternative Minimum Tax Base	<u>\$1,090,000</u>	<u>\$1,090,000</u>

Tentative Minimum Tax <Regular Income Tax>	\$ 301,700 <u><328,597></u>	\$ 301,700 <u><328,597></u>
Alternative Minimum Tax (AMT)	\$ 0	\$ 0
Regular Income Tax	\$ 328,597	\$ 328,597
Allowable Tax Credits	<u>26,897</u>	<u>275,000</u>
Total Tax Liability	\$ <u>301,700</u>	\$ <u>53,597</u>

As the example above illustrates, the new law saves an individual taxpayer \$248,103 in taxes by allowing the rehabilitation tax credits to offset AMT. Prior to the enactment of H.R.3221, the individual shown above was only allowed to claim \$26,897 of RTCs against their regular tax liability, which is the excess of the regular income tax over the “tentative minimum tax.” With the new law, the taxpayer can now claim the entire \$275,000 of rehabilitation tax credits generated from the tax credit project against their aggregate tax liability, including any AMT.

Important Related Tax Issues

Despite the passage of H.R. 3221, other tax hurdles still pose a challenge for individual investors to consider RTC deals a viable investment option.



Historic US Post Office, Havre, MT

For instance, IRC Section 469 regarding “Passive Activities Losses and Credits Limited,” provides limits and restrictions relating to the nature and amount of tax credits allowed to be taken by a taxpayer when dealing with real estate investment activities. The level of participation in the real estate investment activity ultimately decides how the activity is classified and how much of the tax credit received can be claimed in the taxable year.

The three levels of participation are (1) passive activity, (2) active participation, or (3) material participation in rental real estate as a real estate professional. These distinctions are defined in detail below.

Passive Activity

Passive activity means any activity which involves the conduct of any trade or business in which the taxpayer does not actively or materially participate.¹ A limited partner in a limited partnership or an investor member in an LLC are engaged in passive activity. Income derived from such an activity is called “passive income.” Under IRC Section 469, passive activity by definition specifically includes any rental activity.¹ Any tax credit associated with a passive activity is deemed a “passive activity credit.” In general, a passive activity credit is not allowed to be claimed by an individual taxpayer¹ against income derived from active or material activity. The passive activity credit can only be used against tax liability resulting from passive activities.



The Severs Block building in Muskogee. OK

Active Participation

Active participation means direct participation in the decision-making related to the management of a real estate entity. A general partner of a limited partnership or a managing member of an LLC is actively participating in the real estate project. A taxpayer is treated as actively participating in rental real estate activity if his/her interest, including spouse's interest (as further explained in spouse participation below) is more than 10% (by value) of all interests in the rental real estate activity.¹

In general, if a taxpayer is “actively participating” in rental real estate activities, then the taxpayer is allowed to take a \$25,000 deduction against active income in the taxable year that they are actively participating in the rental real estate activities.²

Section 469 limits most individuals to \$25,000 annually in either loss deductions or the deduction equivalent in tax credits derived from passive participation in real estate. But in the case of the RTC, there is no participation requirement to take the \$25,000 deduction.³ The RTC can be claimed with the \$25,000 limit even with active participation in the rental real estate activities. For the RTC, the \$25,000 limit is incrementally phased out by reducing it by 50% of the amount by which the taxpayer's adjusted gross income for the taxable year exceeds \$200,000.⁴

Materially Participate (Real Estate Professional)

In rental real estate transactions, Congress considered the impact of IRC Section 469 on such transactions and enacted specific relief for certain real estate professionals involved in real property trade or business for taxable years beginning after 1993. Real estate professionals and only real estate professionals (REPs) whose real estate activities meet certain definitions can be deemed to be “materially participating” and take an unlimited amount of RTC on an annual basis. The sale of tax credits to these REPs is advantageous because these investors do not have to carry forward the credits⁵ like the non-real estate professional that is limited to \$25,000 per year. RTC carry forwards are allowed for a maximum of 15 years.

The term “real property trade or business” refers to any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.⁶ Some examples of REPs can include real estate agents or brokers, landlords, professional property managers, developers and construction contractors.

In order to be deemed a real estate professional, the taxpayer must materially participate in the real estate activity. In general, a taxpayer shall be treated as materially participating in an activity only if he/she is involved in the operations of the activity on a basis which is regular, continuous and substantial.⁷ Therefore, if the taxpayer can show that he/she materially participates in an activity, then the activity is not a passive activity for such year.⁸ Accordingly, the credits associated with the deemed non-passive activity are not disallowed, and there is no limit on the amount of credits associated with the non-passive activity to be claimed against tax liability.

If the following two conditions are met, then the rental (whether commercial or residential) real estate activities are considered material, and the IRS considers the taxpayer to be a real estate professional.

¹ IRC Section 469(i)(6)(A)

² IRC Section 469(i)(2)

³ IRC Section 469(i)(6)(B)(ii)

⁴ IRC Section 469(i)(3)(B)

⁵ assumes non REPs are unable to claim all available credits in a given year due to passive activity loss limitations

⁶ IRC Section 469(c)(7)(C)

⁷ IRC Section 469(h)(1)

⁸ Federal Treasury Regulation 1.469-1T(e)(1)(i)

(i) more than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and⁹

(ii) such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.¹⁰

But the time worked as an employee in a real estate business does not count for the material participation test unless the employee owns 5 percent or more of the real estate activity.¹¹

For example, if a taxpayer works full time at a construction company, but does not own any percentage of the company, the hours worked do not count towards the material participation test.

As a real estate professional that meets the material participation requirements, the taxpayer can fully deduct losses/credits from the rental activities against both active and passive income or offset tax liabilities with the full amount of the rehabilitation tax credit he/she is entitled to claim.

Spouse Participation

In determining whether a taxpayer materially participates, the participation of the spouse of the taxpayer is taken into account.¹² Furthermore, any participation by such taxpayer's spouse in the activity is treated, for purposes of IRC Section 469 passive activity rules, as participation by such taxpayer in the activity.¹³

Although spousal participation can be combined to determine material participation when filing a joint tax return, one spouse must separately meet both of the conditions for a real estate professional discussed above (i.e. 50% of personal services in real estate businesses and 750 hours in real estate businesses). If neither spouse satisfies both of the conditions, then they are not deemed to be materially participating in real estate activities.

For example, a taxpayer and his wife jointly own two rental real estate properties. The taxpayer owns a construction company and works full time there (approximately 2,080 hours a year). His wife is a part time nurse. She spends about 300 hours a year managing each rental property and the taxpayer has no participation in these rental activities. Since the taxpayer is a REP and his wife spent more than 500 hours participating in the rental activities (assumes aggregation election was made), the taxpayer is deemed to be materially participating in the rental activity even though all the participation was from the taxpayer's wife.

Limited Partnership Interests

Special rules apply to limited partnership interests. To show material participation by taxpayers with interests¹⁴ in limited partnerships or limited liability companies that deal in real property trade or business, taxpayers can elect to treat all interests in various rental real estate properties as a single rental real estate activity.¹⁵ If a taxpayer chooses to do so, *and at least one interest in rental real estate is held by the taxpayer as a limited partnership interest*, the combined rental real estate activity will be treated as a limited partnership interest of the taxpayer for purposes of determining material participation.

⁹ IRC Section 469(c)(7)(B)(i)

¹⁰ IRC Section 469(c)(7)(B)(ii)

¹¹ IRC Section 469(c)(7)(D)(ii)

¹² IRC Section 469(h)(5)

¹³ Federal Treasury Regulation 1.469-5T(f)(3)

¹⁴ Federal Treasury Regulation 1.469-5T(e)(3)

¹⁵ Federal Treasury Regulation 1.469-9(g)(1)

Accordingly, the taxpayer will be treated as materially participating in the combined rental real estate activity if the taxpayer meets the tests listed in Federal Treasury Regulation 1.469-5T(e)(2) (dealing with the tests for determining the material participation of a limited partner).¹⁶

Federal Treasury Regulation 1.469-5T(e)(1) states that an individual taxpayer shall be treated as materially participating in any activity of a limited partnership for purposes of applying section 469 and the related regulations to the taxpayer's share of credits from such activity if¹⁷:

- (i) The individual participates in the activity for more than 500 hours during such year;¹⁸
- (ii) The individual materially participated in the activity for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year; or¹⁹
- (iii) The activity is a personal service activity, and the individual materially participated in the activity for any three taxable years (whether or not consecutive) proceeding the taxable year.²⁰

The term "personal service activity" refers to any activity that involves the performance of personal services in the following:

- (i) Fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting; or²¹
- (ii) Any other trade or business in which capital is not a material income-producing factor.²²

If the taxpayer's share of gross rental income from all of the taxpayer's limited partnership interests in rental real estate is less than ten percent of the taxpayer's share of gross rental income from all of the taxpayer's interests in rental real estate for the taxable year, then the taxpayer may determine material participation under any of the tests listed in Federal Treasury Regulation 1.469-5T(a) that apply to rental real estate activities.²³

Practical Applications for the Developer of Small Historic Properties

Case Study #1 – John Williams is a real estate developer who wants to use the RTC to help rehabilitate a 30,000 square foot Main Street property for use as a restaurant on the first floor and six loft apartments on the second and third floors. He is a real estate professional and is subject to AMT. John is also the managing member of the LLC that owns the building. He has a bridge loan source from Darby Savings Bank that allows him to bridge the receipt of the tax benefits and intends to take the credit himself and reduce his Alternative Minimum Tax. John completes rehabilitation and leases up the building. He repays the bridge loan through project cash flow supplemented by increased personal cash flow derived from the tax credit benefits he receives when he files his tax return for the year he places the building in service.

¹⁶ Federal Treasury Regulation 1.469-9(f)(1)

¹⁷ Federal Treasury Regulation 1.469-5T(e)(2)

¹⁸ Federal Treasury Regulation 1.469-5T(a)(1)

¹⁹ Federal Treasury Regulation 1.469-5T(a)(5)

²⁰ Federal Treasury Regulation 1.469-5T(a)(6)

²¹ Federal Treasury Regulation 1.469-5T(d)(1)

²² Federal Treasury Regulation 1.469-5T(d)(2)

²³ Federal Treasury Regulation 1.469-9(f)(2)

Case Study #2 – Paul Brown is Main Street property owner who does not have experience rehabilitating historic buildings. He is not a real estate professional and cannot find a local bank to bridge the receipt of the RTC benefits. In any case he would only be eligible to offset his federal income taxes with RTCs by the tax equivalent of \$25,000 per year. His credits are worth \$250,000. Paul owns and operates the first floor dry cleaning business and has prospective office tenants for his vacant upper two floors. He needs to find an experienced person who can plan and complete the rehab and someone who can use about \$250,000 in RTCs. Paul hires a local design/build architectural firm to complete the rehabilitation.

He asks his accountant to identify a local real estate professional who is subject to AMT. The accountant identifies two candidates. The first spends at least 500 hours per year engaged in rental real estate activities, one of which is a limited partnership interest. The REP is willing to make an election to aggregate all of his rental real estate activities as one limited partnership interest in which he materially participates, qualifying him to use Paul's \$250,000 in RTCs against both active and passive income and reducing his AMT. The second candidate is also a real estate professional who has sufficient passive income from limited partnership interests to use all of Paul's credits and lower his AMT. Paul decides to go with the second REP because he is a Main Street booster and is offering \$.90 on the dollar (\$225,000) for the RTCs compared to \$.80 offered by the other prospective buyer. Paul's lawyer sets up an LLC and makes Paul the managing member and the second REP as the investor member. At closing, the REP writes Paul a check for \$112,500 with the balance due upon construction completion and lease-up.

Final Thought

Smaller rehabilitation tax credit deals have been greatly impacted by the enactment of H.R. 3221, The Housing and Economic Recovery Act of 2008. The new law provides tax incentives for individual investors now that they may be able to claim rehabilitation tax credit to offset AMT. With the new law, if individual investors can manage to address the other tax issues such as those brought forth by IRC Section 469, then tax relief in the form of rehabilitation tax credits is just on the horizon. Individuals should consult with their tax advisors to determine whether they can benefit from investments in rehabilitation tax credit projects.



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