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THE REAL ESTATE TAX STIMULUS AWARDS

By most accounts, the U.S. economy is in the worst downturn since the 1930s. Political and business leaders have spent considerable time and effort seeking ways to jump start it. On 2/17/09, President Obama signed the American Recovery and Reinvestment Act of 2009 into law.[1] The Act provides $787 billion of investments, including approximately $288 billion of tax relief and incentives intended to stimulate the economy.[2]

Whenever there is glum economic news, people look for bright spots. Less than a week after President Obama signed the Act, the 81st Academy Awards were presented. From that example, and in an effort to point out potential bright news for the real estate industry, the authors present their Real Estate Tax Stimulus Awards to those provisions of the Act that may best assist the real estate industry in its efforts to recover from the current economic conditions.

First-time homebuyer credit expansion—Best Tax Editing

The first-time homebuyer credit is designed to help individuals to more easily afford a house. Lawmakers hope the changes in this credit will provide relief for the ordinary people of "Main Street." However, residential developers (and others working on "Wall Street") are hoping that the credit will lead to increased sales, which would provide them with an indirect stimulus.

Section 36 gives first-time homebuyers a credit on the purchase of a principal residence in the United States.[3] Under prior law, the credit was limited to the lesser of $7,500 or 10% of the purchase price of the principal residence. It was available only for homes purchased after 4/8/08, but before 7/1/09.

For these purposes, "purchase" means an acquisition of property from an unrelated person as determined under Sections 267 and 707(b).[4] In addition, the adjusted basis of the property cannot be determined, in whole or in part, by reference to its adjusted basis in the hands of the person from whom it was acquired.[5] This disqualifies gifts, among other things, as acquisitions. Furthermore, inheritance is statutorily excluded from the definition of a purchase.[6]

If a taxpayer's modified adjusted gross income exceeds $75,000 ($150,000 on a joint return), the maximum credit allowed is reduced by $0.375 for every dollar of excess.[7]

The first-time homebuyer tax credit is a refundable credit. Under prior law, it must be "recaptured" by increasing the taxpayer's tax liability by an amount equal to 6-2/3% of the credit allowed over a 15-year period, starting in the second tax year after the taxpayer initially took advantage of the credit.[8] This resulted in the credit being essentially an interest-free loan from the federal government to the eligible taxpayer.

The Act temporarily modifies the credit for first-time homebuyers buying a principal residence between 1/1/09 and 11/30/09.[9] For qualifying taxpayers, the Act increased the maximum amount of the refundable credit to the lesser of $8,000 or 10% of the purchase price of the principal residence.[10] More importantly, however, the Act waived the "recapture" of the credit for purchases of principal residences in 2009.[11] The other rules and limitations under Section 36 generally remain intact.

Many commentators complained that due to the "recapture" provision of Section 36, the first-time home buyer tax credit was not viewed as a down payment by the residential lending community and, thus, provided only limited impact to those trying to qualify for a loan. Many believe that eliminating the recapture provision will significantly improve this provision's effectiveness.

Cancellation of indebtedness income deferral—Best Tax Effect

No one should be surprised to hear that the credit markets are not operating as effectively as they were a year ago. The reduction or elimination of available credit, plus the gap between the prices sought by buyers and sellers, has caused such downward pressure on property values that it is very common for the debt associated with a property to exceed the fair market value of the prop-

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MANY BELIEVE THAT ELIMINATING THE RECAPTURE PROVISION WILL SIGNIFICANTLY IMPROVE THE EFFECTIVENESS OF THE FIRST-TIME HOMEBUYER CREDIT.

erty encumbered. Because of the "freezing" of the credit markets and the need for many businesses to restructure their debts, Congress sought to reduce the tax burden from such restructuring.

Taxpayers generally must include the amount of cancellation of indebtedness (COD) income in gross income.[12] COD income can be excluded in certain situations—e.g., if the taxpayer is insolvent or bankrupt, or if the debt is "qualifying real property business indebtedness."[13]

The Act adds Section 108(i) to the Code. Under this new subsection, taxpayers can elect to (1) defer COD income from an applicable debt instrument discharged as a result of the taxpayer's reacquisition of the instrument in 2009 or 2010 and (2) include such COD income in income ratably, 20% each year, from 2014 through 2018.

A few of the terms associated with this provision merit further explanation. First, an "applicable debt instrument" is a bond, debenture, note, certificate, or "any other instrument or contractual arrangement constituting indebtedness" issued by "a C corporation, or any other person in connection with the conduct of a trade or business by such person."[14]

Second, reacquisition of an applicable debt instrument means "any acquisition of the debt instrument by (1) the debtor that issued (or is otherwise the obligor under) the debt instrument, or (2) a related person to such debtor."[15] Acquisitions include repurchases of debt for cash, for another debt instrument, for corporate stock or partnership interests, or through a contribution of the debt to capital, as well as by a complete forgiveness of the debt by the holder.[16]

The taxpayer should include the election with her or his return, clearly identifying the debt instrument and including the amounts of deferred COD income.[17] The election is irrevocable and may be applied to each applicable debt instrument separately. A taxpayer who makes the election is precluded from using the general Section 108 exclusions for such applicable debt instrument.[18]

Some events require the acceleration of COD income deferral. These generally include the death of the taxpayer, the liquidation or sale of substantially all of the taxpayer's assets (including those in a title 11 bankruptcy petition or similar case), and the cessation of business by the taxpayer or similar circumstances. If one such event occurs, any amount of income or deduction that is deferred under Section 108(i) is taken into account in the tax year in which the event occurs. If the event is due to the filing of a title 11 bankruptcy petition or something similar, any income or deduction deferred under Section 108(i) is included in taxable income the day before the petition is filed.[19]

Application to partnerships. Various complex issues arise in examining the application of Section 108(i) to a partnership and its partners.

First, the election to defer COD income is made at the partnership (or other pass-through entity) level.[20] To many, this seems to conflict with the fact that federal income tax is actually paid by partners on their allocations of COD income after the exclusions under Section 108(a) are applied at the partner level.[21] The COD deferral election could cause serious questions about fiduciary responsibility if one or more partners would qualify for other Section 108 exclusions. Many partnership agreements are written to grant one partner the right to make all necessary partnership-level tax elections (the "tax matters partner"). When multiple partners would have conflicting results if the COD deferral election were made, a tax matters partner could be in a real quandary when

1 P.L. 111-5, 2/17/09.
2 This figure comes from a White House Web site devoted to the Act. See www.recovery.gov.
3 Section 36(c)(2) refers to the principal residence definition of Section 121. The taxpayer may be ineligible for the credit if he or she meets one of the exceptions in Section 36(d).
4 Sections 36(c)(3), (5). In applying Sections 267(b) and (c), Section 267(c)(4) is treated as providing that the family of an individual shall include only his or her spouse, ancestors, and lineal descendants.
5 Section 36(c)(3)(ii).
6 Section 36(c)(3)(ii)(II).
7 Section 36(b)(2). Further limitations in Section 36 apply to those filing married and filing separately.
8 Section 36(f)(1), Section 36(f)(7). Certain events may cause the acceleration of the "recapture." Sections 36(f)(2)-(4).
9 Section 36(h).
10 Sections 36(a); (b)(1)(A).
11 Section 36(f)(4)(D).
12 Section 61(a)(12).
13 Section 108(a)(1)(D).
14 Section 108(i)(3). Some commentators have questioned how broadly these terms may be read. For example, some have questioned whether this provision would apply to an employee who received a loan to acquire an interest in a partnership that itself conducts a qualifying trade or business. Hopefully, Treasury will address these and other issues when it issues regulatory guidance.
15 Section 108(i)(4)(A). A related person is defined, for these purposes, in Section 108(e)(4), which generally applies Section 267(b) and Section 707(b)(1).
16 Section 108(i)(4)(B).
17 Section 108(i)(5)(B).
18 Section 108(i)(5)(C).
19 Section 108(i)(5)(D)(i).
20 Section 108(i)(5)(D)(iii).
21 Section 108(d)(6).

determining whether or not to make the election, especially if the tax matters partner would prefer to make the election while other partners would prefer that no such election be made.

Second, the COD income deferred by the partnership's filing of the election should be allocated to the partners immediately before the discharge as if such amounts would have been included in the distributive shares of such partners in accordance with Section 704 if such COD income were recognized at such time.[22] This provision was included to make sure only those partners who were partners at the time the COD income deferral election was applied are impacted. In addition, if any such partner, who was a partner at the time the COD income deferral election was applied, sells, exchanges, or redeems his or her partnership interest, any remaining deferred COD income allocable to such partner will be accelerated and recognized by such partner in the tax year in which such event occurs.[23]

Third, the deferral of COD income may also lead to additional issues if, as a result of the discharge of indebtedness, a partner's share of liabilities rises above the partner's tax basis in its interest in the partnership. To alleviate this, Congress included a provision allowing a partner to not account for the decrease in liabilities at the time of the discharge of indebtedness to the extent it would cause the partner to recognize gain under Section 731.[24] Any amount of decrease in partnership liabilities that is deferred is taken into account by such partner at the same time, and to the extent remaining in the same amount, as the partner's allocable share of deferred COD income is recognized.

Fourth, it is unclear how the acceleration provisions in relation to terminations would apply to partnerships. The acceleration of the COD deferred income would occur in the case of "the liquidation or sale of substantially all the assets of the taxpayer, the cessation of business by the taxpayer, or similar circumstances." From this language, it is difficult to ascertain whether a termination of a partnership under Section 708(b)(1)(B) is included in this list of deferral acceleration events because, practically speaking, in most cases the business continues uninterrupted.[25]

Original issue discount (OID). Another rule applies in an exchange of debt for debt (or deemed debt exchanges) if OID is determined. The Act provides that OID may be currently accrued and deducted by the issuer only to the extent that it exceeds the COD income that is deferred.[26] Any deferred OID deductions can be deducted ratably over the five tax years (i.e., 2014 through 2018) in which the COD income is recognized.[27] This rule was implemented to encourage a practice of matching deductions to income.

Applicable high-yield debt obligations (AHYDO). Section 163(e)(5) outlines the general rules for AHYDOs. The Act added a new subparagraph that temporarily suspends the special AHYDO rules for AHYDOs issued between 9/1/08 and 12/31/09.[28] However, the temporary suspension applies only to AHYDOs that were exchanged by the same issuer for an outstanding debt that was not an AHYDO. Additionally, the Act allows the Treasury some flexibility in temporarily modifying the interest rate used in determining whether a debt instrument is an AHYDO.[29]

TAXPAYERS CAN ELECT TO DEFER CERTAIN COD INCOME AND INCLUDE IT IN INCOME RATABLY.

Bonus depreciation extension—Best Recurring Theme

During the last several economic slowdowns, it has become a common practice for lawmakers to enact incentives for capital expenditures. First-year bonus depreciation is a common tool and was most recently enacted early last year.[30] The Act generally extends first-year bonus depreciation under Section 168(k)(2) to include qualifying property placed in service in 2009 and provides a one-year extension for other qualifying property.[31]

Apart from extending many of the dates, the Act did not modify the definition of qualifying property. Thus, taxpayers who acquire qualifying property in 2009—e.g., qualified

[22] Section 108(i)(6).

[23] Section 108(i)(5)(D)(ii).

[24] Section 108(i)(6).

[25] For example, assume a partnership elects to defer COD income recognition under Section 108(i) and shortly thereafter one of its partners has an acceleration event (or merely technically terminates under Section 708(b)(1)(B)). Would the partner be considered to sell, redeem, or exchange its interest in the partnership and, consequently, be required to accelerate its allocable share of the deferred COD income? Hopefully, these and other issues will be addressed by future Treasury regulations as allowed by Congress in Section 108(i)(7).

[26] Section 108(i)(2).

[27] Section 108(i)(2)(A)(ii).

[28] Section 163(e)(5)(F).

[29] Section 163(i)(1).

[30] The Economic Stimulus Act of 2008, P.L. 110-185, 2/13/08.

[31] For example, taxpayers with long-production period property placed in service in 2010 may take the first-year bonus depreciation deduction to the extent of the taxpayer's 2009 expenditures related to such asset.

leasehold improvement property, land improvements, tangible personal property—may continue to benefit from bonus depreciation.[32]

Net operating loss (NOL) deduction carryback—Most Intriguing Legislative Storyline

By far the most surprising final version of a tax provision in the Act was the NOL deduction carryback.

Section 172(b) generally permits a taxpayer to carry a NOL deduction back two years and forward 20 years. The House version of the bill would have allowed taxpayers to elect to carry an NOL back for up to five years, but would have permanently reduced the NOL amount by 10% for all businesses. The only substantial difference between the House and Senate versions was that the Senate version was more taxpayer friendly; deleting the 10% permanent reduction of an NOL carryback (currently applicable only to alternative minimum taxable income NOLs). The conference agreement significantly reduced the applicability of the NOL provisions of the Act by including a provision limiting the NOL carryback to eligible small businesses.

The Act allows eligible small businesses to irrevocably elect up to a five-year carryback of 2008 applicable NOLs.[33] An eligible small business includes a corporation or sole proprietorship with average annual gross receipts of less than $15 million for the three tax years before the NOL tax year.[34] In addition, the eligible small business limitation further restricts participants by including a set of aggregation rules.[35] These rules generally require the average annual gross receipts test to be applied to all persons treated as a single employer. Generally, a controlled group of corporations, as defined in Section 1563(a) and including the further broadening required by Section 52(a), is considered a single employer. Also, employees of partnerships and proprietorships under common control are typically considered employed by a single employer.[36] In addition, affiliated service groups qualify as a single employer.[37]

Although the expanded NOL carryback provision was not included in the Act, President Obama's fiscal year 2010 budget proposals include a line item reading "Expand net operating loss carryback."[38] Certain taxpayers in the real estate industry—e.g., home builders—would obtain a significant benefit from the expanded NOL provisions if they were enacted.

Honorable mention

Below are two other provisions from the Act that are noteworthy for taxpayers in the real estate industry.

Housing tax credit initiatives. The housing tax credit initiatives provided in the Act, and currently found in Section 42, are additional financing sources included to prop up the declining housing tax credit equity market. The grants included in the Act may total $6-$9 billion in subsidies for affordable housing developments.

Temporary reduction of S corp built-in gains recognition period. The Act effectively temporarily reduces the recognition period for net recognized built-in gain of an S corp from ten years to seven for any gains recognized in tax years beginning in 2009 or 2010.[39] Although not entirely clear, this temporary reduction could apply to built-in gain assets held by certain real estate investment trusts.

Conclusion

The stimulus provisions addressed above provide much-anticipated economic relief for the real estate industry. These provisions should be seen as positive developments in an economically challenging environment. In addition to the provisions outlined above, President Obama's recently proposed budget for Fiscal Year 2010 includes a variety of additional provisions that may provide further economic relief to the real estate industry. The provisions found in the Act will, hopefully, help jump-start the economy, obviating the need for another round of Real Estate Tax Stimulus Awards. ■

[32] For more information on qualifying property and other first-year bonus depreciation requirements, see "Bonus Depreciation Strikes Back", 36 Real Estate Taxation 44 (Fourth Quarter 2008).

[33] Applicable 2008 NOLs include an NOL for any tax year ending in 2008 or an NOL for any tax year beginning in 2008. See Section 172(b)(1)(H)(ii).

[34] Section 172(b)(1)(H)(iv), Section 448(c). Because the partners, and not the partnership itself, carry back the NOL, the IRS released logistical guidance on how the eligible small business testing should apply to partners, and how the election should be made, in Rev. Proc 2009-19, 14 IRB 747.

[35] Section 448(c)(2).

[36] Section 52(b).

[37] Section 414(m), Section 414(o).

[38] Chart S-6, "S-6 Mandatory and Recent Proposals," "FY 2010 Final Summary Tables," released on 2/26/09. Chart S-6 is available at www.whitehouse.gov/omb/assets/fy2010_new_era/Summary_Tables2.pdf.

[39] Section 1374(d)(7).