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Legislative Relief for the Exit Tax Issue

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In December of 2000, Congress established the Bipartisan Millennial Housing Commission ("MHC") to examine a variety of issues affecting the United States housing industry, including ways to increase the role of the private sector in providing affordable housing. The Commission created several individual task forces to study specific housing issues. Two such task forces, the Tax Issues Task Force and the Preservation Task Force, collaborated in the preparation of a written report describing the tax-on-sale problem facing investors in affordable housing properties ("Task Force Report").¹ According to the Task Force Report, "affordable housing professionals generally agree that the single largest barrier to . . . preservation of [affordable housing] is the seller's income tax due on sale."²

Over the life of a typical investment in an affordable housing property, an investor will often reach a point when the cumulative depreciation deductions and other tax losses attributable to the investment will exceed the amount of its cash invest-

ment. This, in turn, often results in a negative capital account balance for the investor under the capital account rules prescribed by the federal tax code.³ If the property is sold when a negative capital account exists, the investor must recapture previously claimed tax benefits and realize taxable income in the amount of the negative capital account balance.

These so-called "exit taxes"

are due even if no cash proceeds are realized from the sale of the property. Consequently, unless the sale proceeds cover the income

taxes due on sale, investors have little incentive to sell the properties—especially since no tax would be due on transactions made after the death of the investor.

The Task Force Report cited concern that the tax-on-sale problem may lead to delays in the sale of affordable housing developments to owners who are committed to preserving them as affordable multifamily housing. Such delays, moreover, could carry serious and irreversible consequences to the property's long-term physical and financial viability. The Task Force Report provided a detailed account of the exit tax problem and suggested that a preservation tax credit might be the most effective means of addressing the problem.

The MHC issued its final report to Congress on May 30, 2002. The report included a recommendation that exit tax relief be provided through legislation amending the federal tax code to allow for the creation of a new affordable housing preservation tax credit.

Affordable Housing Preservation Tax Relief Act of 2003

On November 12, 2003, Congressmen Jim Ramstad (R-MN) and Benjamin Cardin (D-MD) introduced legislation entitled the "Affordable Housing Preservation Tax Relief Act of 2003." The bill, identified as H.R. 3485, proposes to add a new section (42A) to the Internal Revenue Code under which an affordable housing preservation tax credit would be made available to facilitate the preservation of multifamily

The single largest barrier to the preservation of affordable housing is the seller's income tax due on sale.

Community Affordable Housing Equity Corp. (CAHEC) was created in 1992. CAHEC's mission is "to raise and invest equity capital in low-income housing tax credit projects, to empower residents living in developments CAHEC helps finance, and to promote home ownership."

CAHEC publishes TechNotes for its constituents in the affordable housing industry.

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For More Information

The Task Force report, "Background Paper: Preservation Tax Incentive," can be found at www.mhc.gov/papers/poppti.doc.

The Affordable Housing Preservation Tax Relief Act of 2003 (H.R. 3485) can be found at www.novoco.com/Legislations/2003/HR_3485.pdf.

housing. The units eligible for this new credit would be those assisted with (1) an insured mortgage under Section 236 or 221(d)(3), (2) project-based Section 8 assistance, (3) a loan insured by the U.S. Department of Agriculture, or (4) low-income housing tax credits (both 9% and 4% credits). The preservation credit would be allocated to state housing agencies annually in the amount of \$1 per capita plus \$1 million.

In order to claim the new preservation tax credit, owners of HUD- or RHS-subsidized projects or LIHTC projects would need to receive an allocation of the credit from the applicable state housing credit agency and sell the project to a preservation entity pursuant to a qualified preservation sale. An allocation, if made, would equal the taxpayer's maximum tax rate multiplied by the gain recognized from the sale, minus the amount of cash or the fair market value of any other property received from the sale.

The bill defines a "preservation entity" as either a housing credit agency (e.g., a state's housing finance agency) or an organization approved by a housing credit agency. The bill defines a "qualified preservation sale" as a sale to a preservation entity that agrees to maintain, with respect to the property, affordability and use restrictions that (1) expire no less than 30 years after the sale or until a foreclosure occurs (for purposes of this article, the "Preservation Use Period"), (2) are legally enforceable, and (3) are consistent with the long-term physical and financial viability and character of the property as affordable housing. The bill appears to give the housing agency the right to deny an allocation request if it determines that the preservation entity's plan for rehabilitation (if any) and operation of the property is not viable for the entire Preservation Use Period.

One area of the bill that would require additional clarification is whether the agencies would be required to follow specific guidelines when making their viability determination. For example, would the agencies have to develop and administer a competitive application process using published scoring criteria and minimum eligibility requirements similar to those used when making 9% LIHTC awards? If so, the added administrative burdens associated with another competitive credit allocation process may not be well received by the agencies.

Nor may the agencies be receptive to assuming other responsibilities regarding compliance, as outlined in the bill. Specifically, after a qualified preservation sale, the property would have to comply throughout the entire Preservation Use Period with the same occupancy and rent restrictions that are applicable to LIHTC properties. The housing credit agencies would be responsible for monitoring the property's affordability and use restrictions and notifying the IRS of noncompliance.

With respect to noncompliance, perhaps the most glaring weakness of H.R. 3485 is the section on recapture. The preservation tax credit would be recaptured if the IRS determines that all or any portion of the property is out of compliance with the requirements of the credit program. No mention is made under the bill of a defined recapture period or some other prescribed date upon which the risk of recapture expires. Because a property's affordability and use restrictions must be maintained for a period of 30 years, those claiming the credit would apparently be subject to recapture risk for 30 years.⁴

Exit Tax Relief in 2004?

The outlook for H.R. 3485 is unclear, although the bill appears to have a tough road ahead. The

only recent activity taken on the bill was the joining of Congressman Ron Paul (R-TX) as a co-sponsor on May 5, 2004. Relatively little time remains for passage in both the House and Senate before the current 108th Congressional session ends later this year. The presidential election will likely have a negative impact on the bill's chances of gaining momentum. If H.R. 3485 fails to pass in the current session, advocates hope that the legislation or a similar version of it will be reintroduced when the 109th Congressional session begins in January 2005.

Notes

¹The Task Force Report, entitled "Background Paper: Preservation Tax Incentive," curiously described the exit tax issue as unique to affordable housing properties acquired at least a year or two before 1986. The report made no mention of properties acquired on or after 1986 utilizing the low-income housing tax credit under Section 42 of the Internal Revenue Code. Despite being glossed over in the Task Force Report, LIHTC investors, especially those who participated in the program during its infancy, are undoubtedly familiar with the exit tax issue.

²"Background Paper," p. 1.

³The degree to which the problem exists will vary depending on the characteristics of each investment. For example, 4% LIHTC properties financed with tax-exempt bonds are more likely to carry exit tax problems than 9% LIHTC properties because of the substantial amount of tax losses generated by such bond-financed properties.

⁴One would reasonably expect that the provisions of H.R. 3485, if enacted into law, would be explained through the adoptions of treasury regulations and various interpretive pronouncements from the IRS.

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