

**PRESENT LAW AND BACKGROUND RELATING TO
TAX INCENTIVES FOR RESIDENTIAL REAL ESTATE**

Scheduled for a Public Hearing
Before the
HOUSE COMMITTEE ON WAYS AND MEANS
on July 13, 2022

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION



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CONTENTS

	<u>Page</u>
INTRODUCTION.....	1
I. TAX INCENTIVES FOR HOMEOWNERSHIP	2
A. Home Mortgage Interest Deduction	2
B. Deduction for Real Property Taxes	5
C. Exclusion of Gain from Sale of a Principal Residence	7
D. Tax Exempt Bonds for Owner-Occupied Housing	8
E. Other Incentives.....	12
1. Qualified first-time homebuyer distribution from an individual retirement plan.....	12
2. Employer-sponsored retirement plan loans.....	13
3. Exclusion from income of certain housing allowances and related deductions...	15
4. Exclusion from gross income of discharge of qualified principal residence indebtedness	17
5. Treatment of tenant-stockholders of cooperative housing corporations.....	19
II. TAX INCENTIVES FOR RENTAL HOUSING	21
A. Low-Income Housing Tax Credit.....	21
B. Rehabilitation Tax Credit.....	25
C. Tax-Exempt Bond Financing for Residential Rental Property	27
D. Accelerated Depreciation for Residential Rental Property.....	28
E. Passive Activity Loss Rules and Special Rental Real Estate Rules	35
III. DATA AND ANALYSIS RELATED TO TAX INCENTIVES FOR HOMEOWNERSHIP	37
IV. DATA AND ANALYSIS RELATED TO TAX INCENTIVES FOR RENTAL HOUSING	47

INTRODUCTION

The House Committee on Ways and Means has scheduled a public hearing on July 13, 2022, entitled “Nowhere to Live: Profits, Disinvestment, and the American Housing Crisis.” This document,¹ prepared by the staff of the Joint Committee on Taxation (“Joint Committee staff”), provides general background on the tax incentives for residential housing. The first part of this document describes the tax provisions that offer incentives for homeownership. The second part describes the tax provisions that offer incentives for rental housing. The third part provides a discussion of the economic incentives and data related to homeownership. The fourth part provides a discussion of the economic incentives and data related to rental housing. Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the “Code”).

¹ This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background Relating to Tax Incentives for Residential Real Estate* (JCX-15-22), July 11, 2022. This document can be found on the Joint Committee on Taxation website, www.jct.gov.

I. TAX INCENTIVES FOR HOMEOWNERSHIP

A. Home Mortgage Interest Deduction

Under an exception to the broad rule disallowing a non-corporate taxpayer a deduction for interest referred to as “personal interest,” an individual taxpayer who elects to itemize deductions instead of claiming the standard deduction is allowed a deduction for qualified residence interest.² Qualified residence interest means interest that an individual taxpayer pays or accrues during the taxable year on acquisition indebtedness with respect to a qualified residence of the taxpayer.³

A qualified residence of an individual taxpayer means the taxpayer’s principal residence (within the meaning of section 121) and one other residence selected by the taxpayer.⁴ Under this definition a house, condominium, cooperative, mobile home, or boat may be considered a qualified residence.⁵

For a taxable year beginning before January 1, 2018 or after December 31, 2025, qualified residence interest also includes interest that an individual taxpayer pays or accrues during the year on home equity indebtedness with respect to the taxpayer’s qualified residence.⁶

Acquisition indebtedness

Acquisition indebtedness is indebtedness that an individual taxpayer incurs in acquiring, constructing, or substantially improving any qualified residence of the taxpayer and that is secured by that residence.⁷

Acquisition indebtedness also generally includes indebtedness that is secured by an individual taxpayer’s qualified residence and that results from the refinancing of indebtedness that was considered acquisition indebtedness either under the general definition (that is, indebtedness that was incurred to acquire, construct, or substantially improve the residence and that was secured by the residence) or under this special rule for refinancing indebtedness.⁸ The amount of refinancing indebtedness that may be treated as acquisition indebtedness under this

² Sec. 163(a), (h)(2). “Personal interest” encompasses interest other than trade or business interest, investment interest, and certain other limited categories of interest including qualified residence interest. Sec. 163(h)(2).

³ Sec. 163(h)(3)(A)(i).

⁴ Sec. 163(h)(4)(A)(i).

⁵ *Ibid.* (referencing the section 280A(d)(1) rules for a “dwelling unit”).

⁶ Sec. 163(h)(3)(A)(ii), (F)(i)(I).

⁷ Sec. 163(h)(3)(B)(i).

⁸ *Ibid.*

special rule is limited to the amount of the acquisition indebtedness that was refinanced.⁹ For example, if an individual taxpayer incurs \$200,000 of acquisition indebtedness to buy a principal residence, repays \$50,000 of the indebtedness, and refinances the remaining \$150,000 of outstanding indebtedness, the individual taxpayer's acquisition indebtedness with respect to the residence may not exceed \$150,000, regardless of the amount of indebtedness that the taxpayer incurs by refinancing acquisition indebtedness.

Under Public Law 115-97, the total amount of indebtedness incurred after December 15, 2017 that may be treated as acquisition indebtedness may not exceed \$750,000 (or \$375,000 in the case of a married individual filing a separate return), a reduction from the prior law limitation of \$1 million (or \$500,000 in the case of a married individual filing a separate return).¹⁰ The limitation on the total amount of indebtedness that may be treated as acquisition indebtedness reverts to the higher \$1 million and \$500,000 amounts in 2026 (regardless of when the indebtedness is incurred).¹¹

Home equity indebtedness

Public Law 115-97 eliminated the deduction for interest paid on home equity indebtedness in any year from 2018 through 2025.¹²

Prepaid interest

If a taxpayer uses the cash method of accounting, prepaid interest -- that is, interest paid by the taxpayer that is properly allocable to a period with respect to which the interest represents a charge for the use or forbearance of money and that is after the close of the taxable year in which paid -- generally must be capitalized and treated as paid in the period to which it is allocable (that is, amortized over the term of the indebtedness).¹³ This rule does not, however, generally apply to points paid in respect of indebtedness incurred in connection with the

⁹ *Ibid.*

¹⁰ Sec. 163(h)(3)(F)(i)(II), (III), (h)(3)(B)(ii). The \$750,000 and \$375,000 limitations are reduced (but not below zero) by the amount of indebtedness that was incurred before December 15, 2017 and is subject to the \$1 million or \$500,000 limitation. Under a special transition rule, if an individual taxpayer entered into a written binding contract before December 15, 2017 to close on the purchase of a principal residence before January 1, 2018 and actually purchased the residence before April 1, 2018, indebtedness incurred on or before April 1, 2018 is not subject to the reduced limitation. Sec. 163(h)(3)(F)(i)(IV).

¹¹ Sec. 163(h)(3)(F)(ii).

¹² Sec. 163(h)(3)(F)(i)(I). For periods before and after the temporary elimination of this deduction, home equity indebtedness means indebtedness secured by the individual taxpayer's qualified residence to the extent the aggregate amount of such indebtedness does not exceed the difference between the fair market value of the residence and the total acquisition indebtedness with respect to the residence, and never in excess of \$100,000 (or \$50,000 for a married individual filing a separate return). Sec. 163(h)(3)(C)(i), (ii). In years not subject to the temporary elimination of the deduction for home equity indebtedness interest, this interest is deductible even if the proceeds of the indebtedness are used to pay costs, such as for vehicles, education, medical care, or vacations, unrelated to a qualified residence.

¹³ Sec. 461(g)(1).

purchase or improvement of, and secured by, a taxpayer's principal residence.¹⁴ As a consequence, if these points would be deductible as qualified residence interest if they were not prepaid, a deduction is generally allowed for the points in the year in which they are paid (but only if the points are paid in respect of indebtedness incurred for the purchase or improvement of an individual taxpayer's principal residence).

Private mortgage insurance

Under a temporary provision that expired at the end of 2021, certain premiums that an individual taxpayer paid or accrued for qualified mortgage insurance in connection with acquisition indebtedness secured by the taxpayer's qualified residence were treated as deductible qualified residence interest.¹⁵ The amount otherwise allowable as a deduction was phased out ratably by 10 percent for each \$1,000 (or \$500 for a married individual filing a separate return) by which the individual taxpayer's adjusted gross income exceeded \$100,000 (or \$50,000 for a married individual filing a separate return).¹⁶

For this purpose, qualified mortgage insurance meant mortgage insurance provided by the Department of Veterans Affairs, the Federal Housing Administration, or the Rural Housing Service, and private mortgage insurance (defined in section 2 of the Homeowners Protection Act of 1998 as in effect on the date of enactment of the temporary qualified mortgage insurance provision (December 20, 2006)).¹⁷

Amounts paid in a taxable year for qualified mortgage insurance that were properly allocable to periods after the close of that year were treated as paid in the period to which they are allocated. No deduction was allowed for the unamortized balance if the mortgage was paid before its term (except in the case of qualified mortgage insurance provided by the Department of Veterans Affairs or Rural Housing Service).¹⁸

The deduction for qualified mortgage insurance premiums was not allowed with respect to any mortgage insurance contract issued before January 1, 2007 and is not allowed for any amount paid or accrued after December 31, 2021, or properly allocable to any period after that date.¹⁹

¹⁴ Sec. 461(g)(2).

¹⁵ Sec. 163(h)(3)(E)(i).

¹⁶ Sec. 163(h)(3)(E)(ii).

¹⁷ Sec. 163(h)(4)(E).

¹⁸ Sec. 163(h)(4)(F).

¹⁹ Sec. 163(h)(3)(E)(iii), (iv).

B. Deduction for Real Property Taxes

An individual taxpayer who itemizes deductions rather than claiming the standard deduction is allowed a deduction for State, local, and foreign, real property taxes.²⁰ An individual taxpayer may deduct the tax if it is based on the assessed value of the real property and the taxing authority charges a uniform rate on all property in its jurisdiction. The tax must be for the welfare of the general public and not be a payment for a special privilege granted or service rendered to the individual taxpayer.²¹

Deductible real property taxes do not include itemized charges for services to specific property or people even if paid to the taxing authority. Charges for services include itemized charges such as a fixed charge per gallon of water used, a periodic charge for residential trash collection service, or a flat fee for a single service provided by the taxing jurisdiction (such as for mowing your lawn because its height exceeded that permitted by local ordinance).

Assessments for local benefits that tend to increase the value of the property are not deductible.²² These include assessments for the construction of new streets and sidewalks, or impact fees to connect to a water or sewer system. Assessments for repair or maintenance or financing costs of existing local benefits are deductible. If only part of the assessment is for repair, maintenance, or financing costs, the taxpayer must be able to show the amount of that part to claim any deduction for that assessment.

Transfer taxes on the sale of a personal residence are not deductible real property taxes. Transfer taxes paid by the buyer are included in the cost basis of the property. Transfer taxes paid by the seller reduce the amount realized on the sale.

Assessments imposed by a homeowners' association are not deductible as real property taxes.

The deduction for real property taxes is not allowed in computing alternative minimum taxable income.²³

Limitation for 2018 through 2025

Under Public Law 115-97,²⁴ the total amount of an individual taxpayer's deduction for State and local real property taxes, State and local personal property taxes, and State and local income, war profits, and excess profits taxes is limited to \$10,000 (\$5,000 for a married

²⁰ Sec. 164(a)(1). In contrast with the deduction for mortgage interest, which is limited to interest in respect of an individual taxpayer's principal residence and one other residence, the deduction for real property taxes is allowed for taxes imposed on any number of an individual taxpayer's residences.

²¹ Treas. Reg. sec. 1.164-3(b).

²² Sec. 164(c)(1).

²³ Sec. 56(b)(1)(A).

²⁴ Sec. 11042.

individual filing a separate return) for a taxable year beginning after December 31, 2017 and before January 1, 2026.²⁵ This limitation does not apply to State and local real property taxes or personal property taxes paid or accrued in carrying on a trade or business or an activity described in section 212 (generally, an activity for the production or collection of income).²⁶

Public Law 115-97 also limits the deduction for foreign real property taxes.²⁷ For taxable years beginning after December 31, 2017 and before January 1, 2026, an individual taxpayer may deduct foreign real property taxes (without regard to the \$10,000 limitation) only if those taxes are paid or accrued in carrying on a trade or business or an activity described in section 212.²⁸ All foreign real property taxes may be deducted in taxable years beginning after December 31, 2025.²⁹

²⁵ Sec. 164(b)(6)(B).

²⁶ Sec. 164(b)(6). These taxes may, though, be subject to limitation under other rules including, for example, the section 469 passive loss rules.

²⁷ Sec. 11042.

²⁸ Sec. 164(a)(1), (b)(6).

²⁹ Sec. 164(a)(1), (b)(6)(A).

C. Exclusion of Gain from Sale of a Principal Residence

An individual taxpayer generally may exclude from gross income up to \$250,000 (or, in the case of a married individual filing a joint return, up to \$500,000) of gain realized on the sale or exchange of a principal residence.³⁰

The exclusion is allowed in respect of an individual taxpayer's sale or exchange of a principal residence only if the taxpayer owned and used the residence as a principal residence for at least two years during the five-year period ending on the date of the sale or exchange. An individual taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or, to the extent provided under regulations, unforeseen circumstances is allowed an exclusion equal to the fraction of the otherwise applicable maximum (\$500,000 for a married individual filing a joint return, or \$250,000 for any other individual taxpayer) that is equal to the fraction of the two years during which the ownership and use requirements are met.

Under an election allowed to members of the uniformed services, the Foreign Service, certain employees of the intelligence community, and employees or volunteers of the Peace Corps, the five-year principal residence testing period that would otherwise end on the date of the sale or exchange of a principal residence may be suspended for any period up to 10 years during which the individual or the individual's spouse is on qualified official extended duty.

Gain from the sale or exchange of a principal residence allocated to periods of nonqualified use is not excluded from gross income. A period of nonqualified use means any period (not including any period before January 1, 2009) during which the property is not used by the individual or the individual's spouse or former spouse as a principal residence. For purposes of determining periods of nonqualified use, (1) any period after the last date on which the property is used as the principal residence of the individual or spouse (regardless of use during that period), and (2) any period (not to exceed two years) during which the individual is temporarily absent by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances, are not taken into account.

The amount of gain allocated to periods of nonqualified use is the amount of gain multiplied by a fraction, the numerator of which is the aggregate periods of nonqualified use during the period the property was owned by the individual taxpayer and the denominator of which is the period during which the individual taxpayer owned the property.

³⁰ Sec. 121.

D. Tax Exempt Bonds for Owner-Occupied Housing

In general

Gross income generally does not include interest received on State or local bonds. State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds which are primarily used to finance governmental functions or that are repaid with governmental funds. Private activity bonds are bonds with respect to which the State or local government serves as a conduit providing financing to nongovernmental persons (*e.g.*, private businesses or individuals). The exclusion from income for interest on State and local bonds only applies to private activity bonds if the bonds are issued for certain permitted purposes (“qualified private activity bonds”). Subject to certain requirements, qualified private activity bonds, including qualified mortgage bonds and qualified veterans’ mortgage bonds (“mortgage revenue bonds”), may be issued to finance owner-occupied housing.³¹

Qualified mortgage bonds

Owner-occupied housing may be financed with the proceeds of qualified mortgage bonds.³² Qualified mortgage bonds are tax-exempt bonds issued to make mortgage loans to eligible mortgagors for the purchase, improvement, or rehabilitation of owner-occupied housing for single-family principal residences (and certain two to four family residences). The Code imposes several limitations on qualified mortgage bonds, including income limitations for homebuyers, purchase price limitations for the homes financed with bond proceeds, a first-time homebuyer requirement, and a new mortgage requirement. The income limitations are satisfied if all the financing provided by an issue is provided for mortgagors (borrowers) whose family incomes do not exceed 115 percent (increased up to 140 percent for high housing cost areas) of the median family income for the metropolitan area or State, whichever is greater, in which the financed residences are located. The income limitations are modified for mortgagors having a family of fewer than three individuals. 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 applicable for that residence.

In addition to these limitations, 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 (the “first-time homebuyer” requirement). Under a special rule, qualified veterans’ mortgage bonds (discussed in more detail below) may be issued, without regard to the first-time homebuyer requirement, to finance mortgages for veterans who served on active duty.

³¹ Sec. 143.

³² Revenue Ruling 91-3, 1991-1 C.B. 31, describes typical financing structures involving qualified mortgage bonds. In one such structure, an individual taxpayer (A) applied to a private lending institution (X) for a Federally subsidized mortgage loan to finance the purchase of a principal residence located in city CI. X made the loan to A and subsequently sold the loan to CI under a preexisting agreement that was in place as of the date of the original loan issued by X to A. CI financed the purchase of the loan with the proceeds of qualified mortgage bonds.

Qualified mortgage bonds may be used only to finance original “new” mortgages (as contrasted with refinancing of existing mortgages). Limited exceptions allow refinancing of construction loans, bridge loans, and similar temporary initial financing.

The income and purchase price limitations are modified for residences in certain economically distressed areas (“targeted area residences”). A targeted area residence is one located in either (1) a census tract in which at least 70 percent of the families have incomes that are 80 percent or less of the State-wide median income or, (2) an area of chronic economic distress. Generally, at least 20 percent of the proceeds of a qualified mortgage issue must be made available for owner financing of targeted area residences for at least one year. For targeted area residences, one-third of the mortgages may be made without regard to any income limits and the income limitations will be satisfied for the remaining two-thirds if made to mortgagors whose family income is 140 percent or less of the applicable median family income. The purchase price limitation is raised from 90 percent to 110 percent of the average area purchase price for targeted area residences. In addition, the first-time homebuyer requirement does not apply to targeted area residences.

Qualified mortgage bonds may be used to finance qualified home-improvement loans and qualified rehabilitation loans. Qualified home-improvement loans are defined as loans to finance alterations, repairs, and improvements on existing residences, but only if such alterations, repairs, and improvements substantially protect or improve the basic livability or energy efficiency of the properties. Qualified home-improvement loans generally may not exceed \$15,000. Qualified rehabilitation loans are loans for rehabilitations of buildings at least 20 years old in which specified portions of the structure are retained and the rehabilitation expenditures represent at least 25 percent of the mortgagor’s adjusted basis in the residence.

If the borrower experiences substantial increases in income and disposes of the subsidized residence within nine years after purchase, the borrower may be liable for a recapture tax. The amount of the tax depends on how long the mortgage was outstanding, the family income, and the amount of gain, if any, the borrower realizes on the sale.

Another restriction requires spending the bond proceeds on eligible mortgages within 42 months after the issue date and applying mortgage loan repayments to redeem bonds (rather than to finance additional mortgages) starting 10 years after the issue date.

Volume limitations on private activity bonds

As with most qualified private activity bonds, issuance of qualified mortgage bonds is subject to annual State volume limitations (the “State volume cap”), which are indexed for inflation. For calendar year 2022, the unified State volume cap for all bonds which are subject to the limitation equals \$110 per resident of the State, or \$335,115,000, if greater.³³

³³ Rev. Proc. 2021-45, 2021-48 I.R.B. 770.

Arbitrage limitations

Interest on a tax-exempt bond becomes taxable if the bond is an arbitrage bond. In general, an arbitrage bond is any bond if a portion of the bond proceeds are reasonably expected to be used directly or indirectly to acquire higher yielding investments or to replace funds that were used directly or indirectly to acquire higher yielding investments.³⁴

In addition to the generally applicable arbitrage rules, mortgage revenue bonds (qualified mortgage bonds and qualified veterans' mortgage bonds) have additional restrictions. In the case of qualified mortgage bonds, the effective rate of interest on mortgage loans provided with an issue of qualified mortgage bonds may not exceed the yield on the issue by more than 1.125 percentage points. This determination is made on a composite basis for the issue rather than on a loan-by-loan basis. Additional rules apply in the case of qualified veterans' mortgage bonds, discussed below.

Mortgage credit certificates

Qualified governmental units can elect to exchange all or a portion of their qualified mortgage bond authority for authority to issue mortgage credit certificates ("MCCs").³⁵ MCCs entitle homebuyers to a nonrefundable income tax credit for a specified percentage of interest paid on mortgage loans on their principal residences. The tax credit provided by the MCC may be carried forward for three years. Once issued, an MCC generally remains in effect as long as the residence being financed is the certificate-recipient's principal residence. MCCs generally are subject to the same eligibility and targeted area requirements as qualified mortgage bonds.

Each MCC is required to represent a credit for at least 10 percent (but not more than 50 percent) of interest paid or incurred during the taxable year on qualifying mortgage indebtedness. The actual dollar amount of an MCC depends on the amount of qualifying interest paid during any particular year and the applicable certificate credit percentage. If the credit percentage exceeds 20 percent, however, the dollar amount of the credit received by the taxpayer for any year may not exceed \$2,000. The three-year carryforward is not permitted for amounts in excess of \$2,000. The recapture rules for qualified mortgage bonds also apply to MCCs if the homeowner experiences substantial increases in income and disposes of the subsidized residence within nine years of purchase.

When a homebuyer receives an MCC, the homebuyer's deduction for interest on the qualifying indebtedness is reduced by the amount of the credit. For example, a homebuyer receiving a 50-percent credit, and making \$4,000 of qualifying mortgage interest payments in a given year, would receive a \$2,000 credit and a deduction for the remaining \$2,000 of interest payments.

³⁴ A second type of general arbitrage limitation requires payment to the United States of certain excess earnings on nonpurpose investments over the yield on the tax-exempt bonds.

³⁵ Sec. 25.

The aggregate amount of MCCs distributed by an electing issuer cannot exceed 25 percent of the volume of qualified mortgage bond authority exchanged by the State or local government for authority to issue MCCs. For example, a State that was authorized to issue \$200 million of qualified mortgage bonds, and that elected to exchange \$100 million of that bond authority, could distribute an aggregate amount of MCCs equal to \$25 million.

Qualified veterans' mortgage bonds

Qualified veterans' mortgage bonds are qualified private activity bonds the proceeds of which are used to make mortgage loans to qualified veterans. The Code imposes limitations on qualified veterans' mortgage bonds, including a veterans' residence requirement, a new mortgage requirement, arbitrage restrictions, and a requirement to secure the bonds through a general obligation pledge by the State. Authority to issue qualified veterans' mortgage bonds is limited to States that had issued such bonds before June 22, 1984. Qualified veterans' mortgage bonds are not subject to the State volume limitations generally applicable to private activity bonds. Instead, annual issuance in each State is subject to a separate State volume limitation. The five States eligible to issue these bonds are Alaska, California, Oregon, Texas, and Wisconsin.

Mortgage loans can be made to veterans who served on active duty and who applied for the financing before the date 25 years after the last date on which such veteran left active service.

The annual volume of qualified veterans' mortgage bonds that can be issued in California (\$340 million) or Texas (\$250 million) is based on the average amount of bonds issued in the respective State between 1979 and 1984. In Alaska, Oregon, and Wisconsin, the annual limit on qualified veterans' mortgage bonds that can be issued is \$100 million each. Unused allocation cannot be carried forward to subsequent years.

E. Other Incentives

1. Qualified first-time homebuyer distribution from an individual retirement plan

Early withdrawal tax

A distribution from a traditional IRA (an IRA that can be funded with deductible contributions) is generally includible in income, except to the extent a portion of the distribution is treated as a recovery of the individual's basis (if any).³⁶ A qualified distribution from a Roth IRA (an IRA that is funded with nondeductible contributions) is excludable from income.³⁷ A distribution from a Roth IRA that is not qualified is includible in income to the extent attributable to earnings.

Unless an exception applies, distributions received from a traditional IRA before attainment of age 59½ and distributions from a Roth IRA that are not qualified are subject to an additional 10-percent early withdrawal tax on the amount that is includible in income.³⁸ This 10-percent early withdrawal tax does not apply to qualified first-time homebuyer distributions.³⁹

Exception for qualified first-time homebuyer distributions

The exception from the 10-percent early withdrawal tax for qualified first-time homebuyer distributions applies to payments or distributions from an IRA of up to \$10,000 that meet certain requirements. To qualify for the exception, the distribution must be used before the close of the 120th day after the day on which the distribution is received to pay qualified acquisition costs with respect to the principal residence⁴⁰ of a first-time homebuyer who is the individual, the individual's spouse, or any child, grandchild, or ancestor of the individual or individual's spouse.⁴¹ Qualified acquisition costs are the costs of acquiring, constructing or reconstructing a residence, and include any usual or reasonable settlement, financing, or other closing costs.

A first-time homebuyer is an individual who has not had an ownership interest in a principal residence during the two-year period ending on the date of acquisition of the principal

³⁶ Sec. 408.

³⁷ Sec. 408A(d)(2). A qualified distribution is a distribution that is made after both (1) the five-taxable-year period beginning with the first taxable year for which the individual first made a contribution to a Roth IRA, and (2) the attainment of age 59½, on account of death or disability, or for qualified first-time homebuyer expenses of up to \$10,000 (within the meaning of sec. 72(t)(2)(F)).

³⁸ Sec. 72(t).

³⁹ Sec. 72(t)(2)(F).

⁴⁰ Within the meaning of sec. 121.

⁴¹ Sec. 72(t)(8). The \$10,000 is a lifetime cap that applies to total qualifying distributions for an individual.

residence to which the distribution relates.⁴² If married, the individual's spouse must also satisfy this no-ownership requirement. The date of acquisition is the date the individual enters into a binding contract to purchase a principal residence or begin construction or reconstruction of such residence.

The 10-percent additional tax on early withdrawals is imposed if the distribution is not used within 120 days of the date of distribution. If the 120-day rule cannot be satisfied because the acquisition or construction of the residence is delayed or cancelled, the individual may recontribute all or part of the amount withdrawn to an IRA prior to the end of the 120-day period without adverse tax consequences.⁴³

2. Employer-sponsored retirement plan loans

Certain employer-sponsored retirement plans, including a section 401(a) qualified retirement plan, a section 403(a) annuity plan, a section 403(b) tax-sheltered annuity plan, and a governmental plan,⁴⁴ may provide loans to participants. Unless the loan satisfies certain requirements in both form and operation, the amount of a retirement plan loan made to a participant or beneficiary is a deemed distribution from the retirement plan.⁴⁵ First, the loan amount must not exceed the lesser of: (1) the greater of (a) 50 percent of the participant's account balance under the plan or (b) \$10,000, or (2) \$50,000 (generally taking into account outstanding balances of previous loans).⁴⁶ Second, the loan's terms must generally provide for a repayment period of not more than five years.⁴⁷ Third, level amortization of loan payments must be made not less frequently than quarterly.⁴⁸ A deemed distribution of an unpaid loan balance generally is taxed in the same manner as an actual distribution, including being subject to a 10-

⁴² Sec. 72(t)(8)(D). A "first-time homebuyer" may be an individual who previously owned a principal residence if that that residence was sold more than two years before the date of acquisition of a new principal residence.

⁴³ Sec. 72(t)(8)(E).

⁴⁴ A governmental plan means any plan, whether or not qualified, established and maintained for its employees by the United States, by a State or political subdivision thereof, or by an agency or instrumentality of any of the foregoing.

⁴⁵ Sec. 72(p)(1).

⁴⁶ Sec. 72(p)(2)(A). There are certain exceptions to this rule for loans, for example, individuals eligible to receive a coronavirus-related distribution under section 2202 of the Coronavirus Aid, Relief, and Economic Security Act, Pub. L. No. 116-136, March 27, 2020, may take a loan during a specified period of time equal to the lesser of the present value of the nonforfeitable accrued benefit of the employee under the plan or \$100,000 (and certain other rules apply to such loans). Special rules for loans also apply for certain individuals impacted by specified disasters, see, e.g., section 302 of Div. EE of the Consolidated Appropriations Act, 2021, Pub. L. No. 116-260, December 27, 2020.

⁴⁷ Sec. 72(p)(2)(B).

⁴⁸ Sec. 72(p)(2)(C). Thus, if an employee stops making payments on a loan before the loan is repaid, a deemed distribution of the outstanding loan balance generally occurs.

percent early distribution tax⁴⁹ (if an actual distribution would have been subject to the tax). A deemed distribution is not eligible for rollover to another eligible retirement plan. Subject to the limit on the amount of loans, which precludes any additional loan that would cause the limit to be exceeded, the rules relating to loans do not limit the number of loans an employee may obtain from a plan. A loan may not be made through the use of any credit card or any other similar arrangement.⁵⁰

Exemption for certain loans from the prohibited transaction rules

Generally, the extension of a loan or credit between a plan and a disqualified person who is a participant (or beneficiary) of the plan is subject to excise taxes⁵¹ on prohibited transactions.⁵² However, an exemption from the prohibited transaction rules applies for a plan loan that: (1) is available to all participants and beneficiaries on a reasonably equivalent basis; (2) is not made available to highly compensated employees⁵³ in amounts greater than the amounts made available to other employees; (3) is made in accordance with specific plan provisions governing plan loans; (4) bears a reasonable rate of interest; and (5) is adequately secured.⁵⁴

Loan proceeds used to purchase a principal residence

A loan from an employer-sponsored retirement plan is exempt from the five-year period repayment rule if the proceeds of the loan are used to acquire any dwelling unit which, within a reasonable time, is to be used as the principal residence⁵⁵ of the participant (a “principal residence plan loan”).⁵⁶ The reasonable time period is determined at the time the loan is made. A principal residence plan loan is not required to be secured by the dwelling unit that is to be used as the participant’s principal residence. In determining whether a loan is treated as for the acquisition of a principal residence, the same tracing rules apply that apply in determining acquisition indebtedness for purposes of the rules disallowing a deduction for personal interest.⁵⁷

⁴⁹ Sec. 72(t).

⁵⁰ Sec. 72(p)(2)(D).

⁵¹ Sec. 4975(a).

⁵² Sec. 4975(c)(1)(B). A disqualified person is generally defined in section 4975(e)(2).

⁵³ As defined in section 414(q).

⁵⁴ Sec. 4975(d)(1). Section 408(b)(1) of the Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406 (“ERISA”) contains a similar exemption from the prohibited transaction rules of ERISA for certain loans.

⁵⁵ As defined under section 121. See also Treas. Reg. sec. 1.121-1.

⁵⁶ Sec. 72(p)(2)(B)(ii).

⁵⁷ The tracing rules under section 163(h)(3)(B) apply for this purpose. See Treas. Reg. sec. 1.72(p)-1, Q & A-7.

While a refinancing cannot qualify as a principal residence plan loan, a loan from an employer-sponsored retirement plan that is used to repay a loan from a third party qualifies as a principal residence plan loan if the plan loan would have qualified as a principal residence plan loan if the proceeds of that loan, rather than the proceeds of the loan from the third party, would have been treated as used to acquire the principal residence.

3. Exclusion from income of certain housing allowances and related deductions

Rental value of parsonages

A minister's housing allowance, known as a "parsonage allowance," is excluded from gross income. Specifically, a "minister of the gospel's" gross income does not include: (1) the rental value of a home furnished as part of the minister's compensation; or (2) the rental allowance paid as part of the minister's compensation, to the extent used to rent or provide a home, and to the extent such allowance does not exceed the fair rental value of the home, including furnishings and appurtenances such as a garage, plus the cost of utilities.⁵⁸

Despite the statutory language describing a "minister of the gospel," the parsonage allowance exclusion is not limited to Christian ministers.⁵⁹

A parsonage allowance is generally includible in net earnings from self-employment for purposes of SECA.⁶⁰

Military housing allowances

Qualified military benefits are not included in gross income.⁶¹ Qualified military benefits include the basic allowance for housing authorized under the Federal statute governing pay and allowances for members of the uniformed services.⁶²

Generally, a qualified military benefit is any allowance or in-kind benefit (other than personal use of a vehicle) that: (1) is received by any member or former member of the uniformed services of the United States or any dependent of such member by reason of such

⁵⁸ Sec. 107.

⁵⁹ *Salkov v. Commissioner*, 46 T.C. 190, 194 (1966). See also Rev. Proc. 2014-3, 2014-1 I.R.B. 111, sec. 3.01(16) (IRS will not rule on whether an individual is a "minister of the gospel" for Federal tax purposes).

⁶⁰ Sec. 1402(a)(8). However, the rental value of any parsonage or any parsonage allowance provided after the individual retires is excluded from net earnings from self-employment, whether or not excludable under section 107.

A parsonage allowance includible in net earnings from self-employment is earned income for purposes of the EITC. See sec. 32(c)(2). However, because the parsonage allowance is excluded from gross income, it is not earned income for purposes of the child tax credit. See sec. 24(d)(1)(B).

⁶¹ Sec. 134.

⁶² 37 U.S.C. sec. 403.

member's status or service as a member of such uniformed services; and (2) was excludable from gross income on September 9, 1986, under any provision of law, regulation, or administrative practice which was in effect on such date.⁶³ Generally, other than certain cost of living adjustments, no modification or adjustment of any qualified military benefit after September 9, 1986, is taken into account for purposes of this exclusion from gross income.⁶⁴

Deductibility of mortgage interest and taxes allocable to tax-free allowances for ministers and military personnel

A homeowner generally may deduct interest paid or accrued on a mortgage on the home (on mortgages up to certain specified dollar amounts)⁶⁵ or real property taxes paid or accrued on the home⁶⁶ (if an election is made to itemize deductions in lieu of taking the standard deduction).⁶⁷

Deductions for expenses allocable to tax-exempt income, such as expenses incurred in earning income on tax-exempt investments, are generally disallowed.⁶⁸

An exception to the disallowance of deductions for expenses allocable to tax-exempt income applies with respect to parsonage allowances and military housing allowances.⁶⁹ The exception applies to an otherwise allocable deduction for interest paid on a mortgage, or real property taxes paid, on the home of the taxpayer in the case of (1) a parsonage allowance, or (2) a military housing allowance. Thus, an individual may claim an otherwise allowable deduction for mortgage interest or real property taxes notwithstanding the receipt of a tax-free parsonage allowance or military housing allowance to purchase the home.

⁶³ Sec. 134(b)(1).

⁶⁴ Sec. 134(b)(2), (3).

⁶⁵ Sec. 163(a), (h)(3).

⁶⁶ Sec. 164(a)(1). This deduction is limited to \$10,000 annually (\$5,000 for married taxpayers filing separately).

⁶⁷ See sec. 63.

⁶⁸ Sec. 265.

⁶⁹ Sec. 265(a)(6). See also Rev. Rul. 83-3, 1983-1 C.B. 72, modified by Rev. Rul. 87-32, 1987-1 C.B. 131 (holding, prior to the enactment of section 265(a)(6), that mortgage interest expense and real property tax expense allocable to a parsonage allowance are not deductible).

4. Exclusion from gross income of discharge of qualified principal residence indebtedness

In general

Gross income generally includes income that is realized by a debtor from the discharge of indebtedness.⁷⁰ This general rule includes exceptions for debtors in Title 11 bankruptcy cases, insolvent debtors, certain student loans, certain farm indebtedness, and certain real property business indebtedness.⁷¹ When discharge of indebtedness income is excluded from gross income under an exception to the general rule, a taxpayer generally is required to reduce certain tax attributes, including basis in property, by the amount of the discharge of indebtedness.⁷²

Ordering rules govern the exclusions from gross income for discharge of indebtedness income.⁷³ The amount of income from the discharge of indebtedness that an insolvent debtor, not in Title 11 bankruptcy, may exclude from gross income is not permitted to exceed the amount by which the debtor is insolvent.⁷⁴ In the case of a discharge in bankruptcy or where the debtor is insolvent, any reduction in basis may not exceed the excess of the aggregate bases of properties held by the taxpayer immediately after the discharge over the aggregate of the liabilities of the taxpayer immediately after the discharge.⁷⁵ In such a case, any discharged debt in excess of this limitation reduces other tax attributes.

For all taxpayers, the amount of discharge of indebtedness income generally is equal to the difference between the adjusted issue price of the debt being cancelled and the amount used to satisfy the debt.⁷⁶ These rules generally apply to the exchange of an old obligation for a new obligation, including a modification of indebtedness that is treated as an exchange (a debt-for-debt exchange).⁷⁷

Qualified principal residence indebtedness

Gross income does not include discharge of indebtedness income by reason of a discharge (in whole or in part) of qualified principal residence indebtedness.⁷⁸ Qualified principal residence indebtedness means acquisition indebtedness with respect to the taxpayer's

⁷⁰ Sec. 61(a)(11). A debt cancellation that constitutes a gift or bequest is not treated as income to the donee debtor. Sec. 102. However, the donor-lender may be subject to gift tax on amounts forgiven. Sec. 2511(a); Treas. Reg. sec. 25.2511-1(a).

⁷¹ Sec. 108(a)(1).

⁷² Secs. 108(b), (c)(1) and 1017.

⁷³ Sec. 108(a)(2).

⁷⁴ Sec. 108(a)(3).

⁷⁵ Sec. 1017(b)(2).

⁷⁶ See sec. 1001(b); Treas. Reg. sec. 1.1001-2.

⁷⁷ See Treas. Reg. sec. 1.1001-3.

⁷⁸ Sec. 108(a)(1)(E).

principal residence.⁷⁹ Only \$750,000 of indebtedness (\$375,000 in the case of a married filing separate taxpayer) may be taken into account as qualified principal residence indebtedness.⁸⁰ Acquisition indebtedness with respect to a principal residence generally means indebtedness which is incurred in the acquisition, construction, or substantial improvement of the principal residence of the individual and is secured by the residence.⁸¹ It also includes refinancing of such indebtedness to the extent the amount of the indebtedness resulting from such refinancing does not exceed the amount of the refinanced indebtedness.⁸² For these purposes, the term “principal residence” has the same meaning as under section 121.⁸³

If, immediately before the discharge, only a portion of a discharged indebtedness is qualified principal residence indebtedness, the exclusion applies only to so much of the amount discharged as exceeds the portion of the debt which is not qualified principal residence indebtedness. Thus, assume that a principal residence is secured by an indebtedness of \$750,000, of which \$450,000 is qualified principal residence indebtedness and \$300,000 is not qualified principal residence indebtedness. If the residence is sold for \$350,000 and \$400,000 of debt is discharged, then only \$100,000⁸⁴ of the amount discharged may be excluded from gross income under the qualified principal residence indebtedness exclusion.

The individual’s basis in the principal residence is reduced by the amount excluded from income.⁸⁵

The qualified principal residence indebtedness exclusion does not apply to a taxpayer in a Title 11 case; instead, the general exclusion rules apply.⁸⁶ In the case of an insolvent taxpayer not in a Title 11 case, the qualified principal residence indebtedness exclusion applies unless the taxpayer elects to have the general exclusion rules apply instead.⁸⁷

⁷⁹ Sec. 108(h)(2). Acquisition indebtedness has the meaning given by section 163(h)(3)(B).

⁸⁰ This limitation is the same as the limitation on indebtedness for purposes of the deduction on interest on qualified residence acquisition indebtedness, for taxable years beginning before January 1, 2026. See sec. 163(h)(3)(F)(i)(II).

⁸¹ Sec. 163(h)(3)(B).

⁸² *Ibid.*

⁸³ Sec. 108(h)(5).

⁸⁴ \$400,000 minus \$300,000.

⁸⁵ Sec. 108(h)(1).

⁸⁶ Sec. 108(b)(2)(A).

⁸⁷ Sec. 108(b)(2)(C).

The exclusion does not apply to the discharge of a loan if the discharge is on account of services performed for the lender or any other factor not directly related to a decline in the value of the residence or to the financial condition of the taxpayer.⁸⁸

The exclusion for qualified principal residence indebtedness is effective for discharges of indebtedness before January 1, 2026 or subject to an arrangement that is entered into and evidenced in writing before January 1, 2026.⁸⁹

5. Treatment of tenant-stockholders of cooperative housing corporations

A cooperative housing corporation is an ownership structure under local law. In general, under this structure, a cooperative housing corporation owns residential real property. Owners of the cooperative housing corporation, known as tenant-stockholders, own shares in the corporation and a related proprietary lease, which entitles each owner to occupy a unit in the property. The tenant shareholders pay fees to the cooperative housing corporation, which uses the fees for the care of the property.

The cooperative housing corporation includes the fees received in income, but may generally deduct taxes, interest, maintenance and other costs as trade or business expenses.⁹⁰

A tenant-stockholder is allowed a deduction for a portion of the fee paid to the cooperative housing corporation. The cooperative housing corporation must be a corporation (1) that has one class of stock, (2) each of the stockholders of which is entitled, solely by reason of ownership of stock in the corporation, to occupy a dwelling owned or leased by the cooperative, (3) no stockholder of which is entitled to receive any distribution not out of earnings and profits of the corporation, except on complete or partial liquidation of the corporation, and (4) that meets one of the following three requirements: (a) 80 percent or more of the corporation's gross income for that taxable year is derived from tenant-stockholders; (b) at all times during that taxable year 80 percent or more of the total square footage of the corporation's property is used or available for use by the tenant-stockholders for residential purposes or purposes ancillary to such residential use; or (c) 90 percent or more of the expenditures of the corporation paid or incurred during that taxable year are paid or incurred for the acquisition, construction, management, maintenance, or care of the corporation's property for the benefit of tenant-stockholders.⁹¹

A tenant-stockholder in a cooperative housing corporation is allowed a deduction for amounts paid or accrued to the cooperative housing corporation to the extent those amounts represent the tenant-stockholder's proportionate share of (1) real estate taxes⁹² allowable as a

⁸⁸ Sec. 108(h)(3).

⁸⁹ Sec. 108(a)(1)(E).

⁹⁰ See sec. 162.

⁹¹ Sec. 216(b)(2).

⁹² See sec. 164; see also sec. 164(b)(6) (limiting the amount of State and local taxes that may be deducted).

deduction to the corporation which are paid or incurred by the corporation on the corporation's land or buildings and (2) interest⁹³ allowable as a deduction to the corporation that is paid or incurred by the corporation on its indebtedness contracted in the acquisition of the corporation's land or in the acquisition, construction, alteration, rehabilitation, or maintenance of the corporation's buildings.⁹⁴

⁹³ See sec. 163.

⁹⁴ See sec. 216(a).

II. TAX INCENTIVES FOR RENTAL HOUSING

A. Low-Income Housing Tax Credit

A taxpayer may claim the low-income housing tax credit annually over a 10-year period for the costs of building or rehabilitating rental housing occupied by low-income tenants. The amount of credit that may be claimed each year is an amount equal to the applicable percentage of the qualified basis of each qualified low-income building.⁹⁵

Credit calculations

The applicable percentage for non-Federally subsidized newly constructed housing and non-Federally subsidized substantial rehabilitation is calculated such that the present value of the 10 annual credit amounts equals 70 percent of a building's qualified basis.⁹⁶ The applicable percentage is adjusted monthly by the IRS on a discounted after-tax basis (assuming a 28-percent tax rate) based on the average of the annual applicable Federal rate ("AFR") for mid-term and long-term obligations for the month the building is placed in service.⁹⁷ However, under the Housing and Economic Recovery Act of 2008, the minimum applicable percentage for such credits was temporarily set at nine percent. The Consolidated Appropriations Act, 2016 made the nine-percent minimum applicable rate permanent. These credits are sometimes referred to as "nine-percent credits."

The applicable percentage for Federally subsidized newly constructed housing, Federally subsidized substantial rehabilitation, and certain housing acquisition costs is calculated such that the present value of the 10 annual credit amounts equals 30 percent of a building's qualified basis. The applicable percentage is adjusted monthly by the IRS on a discounted after-tax basis (assuming a 28-percent tax rate) based on the average of the annual AFR for mid-term and long-term obligations for the month the building is placed in service. However, under the Consolidated Appropriations Act, 2020, the minimum applicable percentage for such credits was set at four percent. These credits are sometimes referred to as "four-percent credits."

Generally, buildings located in certain census tracts and difficult development areas, as designated by the Secretary of Housing and Urban Development, are eligible for increased

⁹⁵ Sec. 42(a).

⁹⁶ See sec. 42(b)(1)(B) and (e).

⁹⁷ For July 2022, 72 percent of the average of the AFR for mid-term and long-term obligations based on annual compounding is 2.24 percent. The appropriate percentage for the 70 percent present value credit would be 7.72 percent, and for the 30 percent present value credit, 3.31 percent. However, because of the minimum applicable percentages in effect, the actual percentages are nine percent and four percent, respectively. The minimum nine-percent applicable percentage results in a stream of low-income housing credits with a present value equal to approximately 82 percent of a building's qualified basis. The minimum four-percent applicable percentage results in a stream of low-income housing credits with a present value equal to approximately 36 percent of a building's qualified basis. Rev. Rul. 2022-12, 2022-27 I.R.B. 1, June 15, 2022, and Joint Committee staff calculations.

housing credit.⁹⁸ The increase in housing credit is effected by increasing a building's eligible basis from 100 to 130 percent of the otherwise applicable eligible basis (in the case of a new building) or rehabilitation expenditures (in the case of an existing building). A building designated by a State housing credit agency as requiring an increase in credit in order to be financially feasible is treated as being located in a difficult development area.

State housing credit ceiling

Generally, the low-income housing tax credit is allowable only if the taxpayer receives a housing credit allocation from a State or local housing credit agency. The aggregate credit authority provided annually to each State for calendar year 2022 is \$2.60 multiplied by the State population, with a minimum annual cap of \$2,975,000 for certain small population States.⁹⁹ The amount of housing credit allocated to a low-income building reduces the State housing credit ceiling only once, in the year the housing credit is allocated. For example, \$100 of allocated credits equates to \$100 of credits annually for a period of 10 years, or a total of \$1,000 of credits. However, credit allocations are not needed for buildings that receive 50 percent or more of their financing from the proceeds of tax-exempt bonds that are subject to the private activity bond volume limit, which are discussed further in section II.C of this document.¹⁰⁰

Qualified low-income housing projects and qualified low-income buildings

A qualified low-income building is a building that is subject to a 15-year compliance period and is part of a qualified low-income housing project. A qualified low-income housing project is a project that meets the minimum set-aside requirement and other requirements with respect to the set-aside units at all times during the 15-year compliance period. Generally, buildings are also subject to a 15-year extended-use period following the 15-year compliance period, during which time the buildings remain subject to housing affordability restrictions.¹⁰¹

⁹⁸ Sec. 42(d)(5).

⁹⁹ See Rev. Proc. 2021-45, 2021-48 I.R.B. 764, November 10, 2021. For calendar years 2018, 2019, 2020, and 2021, the State housing credit ceiling was increased by multiplying the State housing credit ceiling amount by 1.125. Sec. 42(h)(3)(I). For calendar year 2022, the small population States are Alaska, Delaware, the District of Columbia, Montana, North Dakota, Rhode Island, South Dakota, Vermont, and Wyoming. See Notice 2022-12, 2022-12 I.R.B. 907, March 18, 2022.

¹⁰⁰ Sec 42(h)(4)(B). If less than 50 percent of a building is financed with tax-exempt bonds, only the portion of credits attributable to the bond-financed portion of the building is allowed without a location. Sec. 42(h)(4)(A).

¹⁰¹ See sec. 42(h)(6).

Minimum set-aside requirement

To meet the minimum set-aside requirement, a qualified low-income housing project must satisfy one of three tests (whichever is elected by the taxpayer):¹⁰²

- 20-50 test. The 20-50 test is met if 20 percent or more of the residential units in the project are both rent-restricted and occupied by tenants whose income is 50 percent or less of area median gross income.¹⁰³
- 40-60 test. The 40-60 test is met if 40 percent or more of the residential units in such project are both rent-restricted and occupied by tenants whose income is 60 percent or less of area median gross income.
- Average income test. The average income test is met if 40 percent or more (25 percent or more in the case of a project located in a high cost housing area) of the residential units in such project are both rent-restricted and occupied by tenants whose income does not exceed the imputed income limitation designated by the taxpayer with respect to the respective unit. The imputed income limitation is determined in 10-percentage-point increments, and may be designated as 20, 30, 40, 50, 60, 70, or 80 percent. The average of the imputed income limitations designated must not exceed 60 percent of area median gross income.¹⁰⁴

Placed in service rules

Generally, a building must be placed in service in the calendar year in which it is allocated credits (the “allocation year”).¹⁰⁵ However, many buildings are not sufficiently completed to be placed in service in the allocation year and require a carryover allocation to allow them to qualify for credits in a subsequent year. To qualify for a carryover allocation, the taxpayer must spend more than 10 percent of the taxpayer’s reasonably expected basis in the building (as of the close of the second calendar year following the allocation year) within one

¹⁰² Sec. 42(g)(1). Nationally, a majority of new units satisfy the minimum set-aside requirement using the 40-60 test, but from 2019 to 2021, an increasing share of new units have used the average income test. In 2019, 84.4 percent of new units used the 40-60 test and only 10.1 percent of new units used the average income test. In 2021, 78.1 percent of new units used the 40-60 test and 14.4 percent of new units used the average income test. NCSHA, HFA Factbook: 2021 Annual Survey Results, Table 9.

¹⁰³ Area median gross income is adjusted for family size and based on annual estimates produced by the Department of Housing and Urban Development. Notice 88-80, 1988-30 I.R.B. 28, July 25, 1988.

¹⁰⁴ In October 2020, Treasury published proposed regulations setting forth guidance on administering the average income test. 85 Fed. Reg. 68816, October 30, 2020. The Biden Administration has indicated that Treasury plans to finalize the average income regulations by the end of September 2022. The White House, *President Biden Announces New Actions to Ease the Burden of Housing Costs*, May 16, 2022, available at <https://www.whitehouse.gov/briefing-room/statements-releases/2022/05/16/president-biden-announces-new-actions-to-ease-the-burden-of-housing-costs/>.

¹⁰⁵ Sec. 42(h)(1)(B).

year of the date that the allocation was made.¹⁰⁶ Such building generally must be placed in service by the end of the second calendar year following the allocation year.

The IRS defines the placed-in-service date for new or existing buildings as “the date on which the building is ready and available for its specifically assigned function, *i.e.*, the date on which the first unit in the building is suitable for occupancy in accordance with [S]tate or local law.”¹⁰⁷ Certain rehabilitation expenditures, which are treated as separate new buildings for purposes of the credit, are treated as placed in service at the end of any 24-month period over which the expenditures are incurred.¹⁰⁸

Qualified allocation plans

The low-income housing credit must be allocated pursuant to a housing credit agency’s qualified allocation plan (a “QAP”).¹⁰⁹ A QAP is defined as any plan that (1) sets forth the selection criteria to be used to determine the housing priorities of the housing credit agency which are appropriate to local conditions, (2) which give preference in allocating housing credit to certain projects (*e.g.*, projects serving the lowest income tenants), and (3) which provide a procedure that the agency will follow in monitoring for noncompliance and in notifying the IRS of such noncompliance and in monitoring for noncompliance with habitability standards through regular site visits.¹¹⁰ QAPs must include the following selection criteria: project location, housing needs characteristics, project characteristics, sponsor characteristics, tenant populations with special housing needs, public housing waiting lists, tenant populations of individuals with children, projects intended for eventual tenant ownership, the energy efficiency of the project, and the historic nature of the project.¹¹¹

¹⁰⁶ Sec. 42(h)(1)(E).

¹⁰⁷ See Notice 88-116, 1988-2 C.B. 44.

¹⁰⁸ Sec. 42(e)(4)(A).

¹⁰⁹ Sec. 42(m).

¹¹⁰ Sec. 42(m)(1)(B).

¹¹¹ Sec. 42(m)(1)(C).

B. Rehabilitation Tax Credit

A 20-percent tax credit is provided for qualified rehabilitation expenditures with respect to a certified historic structure that has been substantially rehabilitated, for which depreciation or amortization is allowable, and that meets other requirements to be a qualified rehabilitated building.¹¹² The credit is generally allowable ratably in each taxable year over the five-year period beginning in the taxable year in which the qualified rehabilitated building is placed in service, for amounts paid or incurred after December 31, 2017.¹¹³

The basis of the property is reduced by the amount of the rehabilitation credit.¹¹⁴

A certified historic structure means any building that is listed in the National Register, or that is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.

For qualified rehabilitation expenditures to be eligible for the credit, the building must be substantially rehabilitated. A building is treated as having met the substantial rehabilitation requirement only if the rehabilitation expenditures during the 24-month period selected by the taxpayer and ending within the taxable year exceed the greater of (1) the adjusted basis of the building (and its structural components), or (2) \$5,000.¹¹⁵ Taxpayers are required to use straight-line depreciation or in certain circumstances the alternative depreciation method in order for rehabilitation expenditures to be treated as qualified.

Qualified rehabilitation expenditures with respect residential property generally do not include any expenditure in connection with the rehabilitation of the portion of a building that is (or is expected to be) leased to a tax-exempt entity.¹¹⁶ In the case of nonresidential real property, qualified rehabilitation expenditures generally do not include any expenditure in connection with the rehabilitation of a building that is more than 50 percent leased to a tax-

¹¹² Sec. 47. A qualified rehabilitated building is defined in section 47(c)(1).

¹¹³ Sec. 47(b). The provision was modified by section 13402 of Pub. L. No. 115-97 (enacted December 22, 2017) generally to repeal the prior-law credit for pre-1936 buildings, and to provide that the 20-percent credit for qualified rehabilitation expenditures in the case of a certified historic building is allowable ratably over a five-year period for amounts paid or incurred after December 31, 2017. A transition rule with respect to the credit allowable under prior law with respect to any building owned or leased (as provided under prior law) by the taxpayer at all times on or after January 1, 2018, provides that the 24-month period selected by the taxpayer (or the 60-month period selected by the taxpayer under the rule for phased rehabilitation) begins not later than the end of the 180-day period beginning on the date of enactment (December 22, 2017), and the amendments made by the provision apply to such expenditures paid or incurred after the end of the taxable year in which such 24-month (or 60-month) period ends.

¹¹⁴ Sec. 50(c). The amount of the basis reduction is the full amount of the credit. See Treas. Reg. secs. 1.47-7(d) and 1.47-7(e), example 2.

¹¹⁵ Sec. 47(c)(1)(B). A special rule for phased rehabilitation substitutes a 60-month period for the 24-month period. Sec. 47(c)(1)(B)(ii).

¹¹⁶ Secs. 47(c)(2)(B)(v) and 168(h).

exempt entity in a disqualified lease. In general, a disqualified lease includes a lease of tax-exempt-bond-financed property, a lease with a sale option (or its equivalent) to the tax-exempt entity, a lease with a term greater than 20 years, or a sale-leaseback arrangement involving a tax-exempt entity.¹¹⁷ For this purpose, a tax-exempt entity generally includes the United States, a state or political subdivision, possession, or any agency or instrumentality of the foregoing ("governmental entity").¹¹⁸

A recapture rule applies if the credit property is disposed of, or otherwise ceases to be credit property with respect to the taxpayer, within a five-year recapture period after the property is placed in service.¹¹⁹

¹¹⁷ Sec. 168(h)(1)(B).

¹¹⁸ Sec. 168(h)(2). Certain exceptions also apply.

¹¹⁹ Sec. 50(a).

C. Tax-Exempt Bond Financing for Residential Rental Property

In general

Private activity bonds are bonds with respect to which the State or local government serves as a conduit providing financing to nongovernmental persons (*e.g.*, private businesses or individuals). 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, 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.”¹²⁰ The standard for a qualified residential rental project is similar to the standard for a qualified low-income housing project for purposes of the low-income housing tax credit. That is, 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”), which are indexed for inflation. For calendar year 2022, the unified State volume cap for all bonds which are subject to the limitation equals \$110 per resident of the State, or \$335,115,000, if greater.¹²¹

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.

¹²⁰ Sec. 142(d).

¹²¹ Rev. Proc. 2021-45, 2021-48 I.R.B. 770.

D. Accelerated Depreciation for Residential Rental Property

Depreciation in general

A taxpayer generally must capitalize the cost of property used in a trade or business or held for the production of income and recover such cost over time through annual deductions for depreciation or amortization.¹²² The period for depreciation or amortization generally begins when the asset is placed in service by the taxpayer.¹²³ Tangible property generally is depreciated under the modified accelerated cost recovery system (“MACRS”), which determines depreciation for different types of property based on an assigned applicable depreciation method, recovery period, and placed in service convention.¹²⁴

Real property

Recovery period and depreciation method

The applicable recovery period for an asset is determined in part by statute¹²⁵ and in part by historic Treasury guidance.¹²⁶ The “type of property” of an asset is used to determine the “class life” of the asset, which in turn dictates the applicable recovery period for the asset. The recovery periods for most real property are 39 years for nonresidential real property and 27.5 years for residential rental property.¹²⁷ The straight line depreciation method is required for the aforementioned real property.¹²⁸

For depreciation purposes, residential rental property is defined as a building or structure with respect to which 80 percent or more of the gross rental income is rental income from dwelling units. The term “dwelling unit” means a house or apartment used to provide living accommodations, but does not include a unit in a hotel, motel or other establishment more than

¹²² See secs. 263(a) and 167 (and the regulations thereunder). In general, only the tax owner of property (*i.e.*, the taxpayer with the benefits and burdens of ownership) is entitled to claim tax benefits such as cost recovery deductions with respect to the property. In addition, where property is not used exclusively in a taxpayer’s business, the amount eligible for a deduction must be reduced by the amount related to personal use. See, *e.g.*, sec. 280A.

¹²³ See Treas. Reg. secs. 1.167(a)-10(b), -3, -14, and 1.197-2(f). See also Treas. Reg. sec. 1.167(a)-11(e)(1)(i).

¹²⁴ Sec. 168.

¹²⁵ See sec. 168(e) and (g).

¹²⁶ Exercising authority granted by Congress, the Secretary issued Rev. Proc. 87-56, 1987-2 C.B. 674, laying out the framework of recovery periods for enumerated classes of assets. The Secretary clarified and modified the list of asset classes in Rev. Proc. 88-22, 1988-1 C.B. 785. In November 1988, Congress revoked the Secretary’s authority to modify the class lives of depreciable property. Rev. Proc. 87-56, as modified, remains in effect except to the extent that the Congress has, since 1988, statutorily modified the recovery period for certain depreciable assets, effectively superseding any administrative guidance with regard to such property.

¹²⁷ Sec. 168(c).

¹²⁸ Sec. 168(b)(3)(A) and (B).

one-half of the units in which are used on a transient basis. If any portion of the building or structure is occupied by the taxpayer, the gross rental income from such property includes the rental value of the portion so occupied. Alternatively, the term “nonresidential real property” means section 1250 property that is not residential rental property or property with a class life of less than 27.5 years.

Placed in service convention

Depreciation of an asset begins when the asset is deemed to be placed in service under the applicable convention.¹²⁹ Under MACRS, nonresidential real property and residential rental property are subject to the mid-month convention, which treats all property placed in service during any month (or disposed of during any month) as placed in service (or disposed of) on the mid-point of such month.¹³⁰

Additions or improvements to property

The recovery period for any addition or improvement to real or personal property begins on the later of (1) the date on which the addition or improvement is placed in service, or (2) the date on which the property with respect to which such addition or improvement is made is placed in service.¹³¹ Any MACRS deduction for an addition or improvement to any property is to be computed in the same manner as the deduction for the underlying property would be if such property were placed in service at the same time as such addition or improvement. Thus, for example, the cost of an improvement to a building that constitutes nonresidential real property is generally recovered over 39 years using the straight line method and mid-month convention. However, an exception to the 39-year recovery period applies to qualified improvement property, as described below.

Qualified improvement property

Qualified improvement property is any improvement made by the taxpayer to an interior portion of a building that is nonresidential real property if such improvement is placed in service by the taxpayer after the date such building was first placed in service by any taxpayer.¹³² Qualified improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building.¹³³ Qualified improvement property is generally depreciable using the

¹²⁹ Treas. Reg. sec. 1.167(a)-10(b).

¹³⁰ Sec. 168(d)(2) and (d)(4)(B).

¹³¹ Sec. 168(i)(6).

¹³² Sec. 168(e)(6)(A).

¹³³ Sec. 168(e)(6)(B).

straight line method,¹³⁴ half-year convention,¹³⁵ and a 15-year recovery period.¹³⁶ Improvements made to residential rental property do not meet the definition of qualified improvement property. Hence, the cost of an improvement to residential rental property is generally recovered over 27.5 years using the straight line method and mid-month convention.

Land and land improvements

Land is generally not depreciable.¹³⁷ However, certain improvements to land (*e.g.*, sidewalks, roads, fencing, shrubbery) are depreciable if they are subject to wear and tear, to decay or decline from natural causes, to exhaustion, and/or to obsolescence.¹³⁸ The cost of depreciable land improvements is generally recovered using the 150 percent declining balance method,¹³⁹ a recovery period of 15 years,¹⁴⁰ and the half-year convention.¹⁴¹

¹³⁴ Sec. 168(b)(3)(G).

¹³⁵ Sec. 168(d)(1). The half-year convention treats all property placed in service during any taxable year (or disposed of during any taxable year) as placed in service (or disposed of) on the mid-point of such taxable year. Sec. 168(d)(4)(A). However, if substantial property is placed in service during the last three months of a taxable year, a special rule requires use of the mid-quarter convention, which treats all property placed in service (or disposed of) during any quarter as placed in service (or disposed of) on the mid-point of such quarter. Sec. 168(d)(3) and (d)(4)(C). The mid-quarter convention does not apply to nonresidential real property or residential rental property; thus, such property is not taken into account in determining if the mid-quarter convention applies. Sec. 168(d)(3)(B); Treas. Reg. sec. 1.168(d)-1.

¹³⁶ Sec. 168(e)(3)(E)(vii). Note that as 15-year property, qualified improvement property is generally eligible for the additional first-year depreciation deduction under section 168(k). Qualified improvement property is also eligible for section 179 expensing. See sec. 179(e)(1). Note that the amount of the additional first-year depreciation deduction is determined after basis adjustments for any section 179 expensing. See Treas. Reg. sec. 1.168(k)-1(a)(2)(iii). For a discussion of expensing under sections 168(k) and 179, see Joint Committee on Taxation, *Tax Incentives for Domestic Manufacturing* (JCX-15-21), March 12, 2021, pp. 7-14.

¹³⁷ Treas. Reg. sec. 1.167(a)-2. See also Treas. Reg. sec. 1.263(a)-1 through -3 (requirements to capitalize amounts paid to acquire, produce, or improve tangible property).

¹³⁸ *Ibid.*

¹³⁹ Under the 150 percent declining balance method, the depreciation rate is determined by dividing 150 percent by the appropriate recovery period, switching to the straight line method for the first taxable year where using the straight line method with respect to the adjusted basis as of the beginning of that year yields a larger depreciation allowance. Sec. 168(b)(1) and (b)(2).

¹⁴⁰ See asset class 00.3 of Rev. Proc. 87-56, 1987-2 C.B. 674. Note that as 15-year property, depreciable land improvements are generally eligible for the additional first-year depreciation deduction under section 168(k).

¹⁴¹ See sec. 168(b)(2)(A) and asset class 00.3 of Revenue Procedure 87-56, 1987-2 C.B. 674.

Alternative depreciation system

The alternative depreciation system (“ADS”) is required to be used for tangible property used predominantly outside the United States,¹⁴² certain tax-exempt use property,¹⁴³ tax-exempt bond financed property,¹⁴⁴ certain imported property covered by an Executive order,¹⁴⁵ and certain property held by either a real property trade or business¹⁴⁶ or a farming business¹⁴⁷ electing out of the business interest limitation under section 163(j).¹⁴⁸ In addition, an election to use ADS is available to taxpayers for any class of property for any taxable year.¹⁴⁹

Under ADS, all property is depreciated using the straight line method and the applicable convention over recovery periods which generally are equal to the class life of the property, with certain exceptions.¹⁵⁰ For example, nonresidential real property has a 40-year ADS recovery period, residential rental property generally has a 30-year ADS recovery period, qualified improvement property has a 20-year ADS recovery period, and land improvements generally have a 20-year ADS recovery period.

Depreciation recapture

In general

Upon disposition of most property used in a business with respect to which depreciation or amortization deductions were taken, the treatment of the resulting gain or loss as ordinary or capital depends on whether there is a net gain or a net loss under section 1231.¹⁵¹ If the netting

¹⁴² Sec. 168(g)(1)(A).

¹⁴³ Sec. 168(g)(1)(B).

¹⁴⁴ Sec. 168(g)(1)(C).

¹⁴⁵ Sec. 168(g)(1)(D).

¹⁴⁶ Sec. 168(g)(1)(F) and (g)(8). An electing real property trade or business is defined in section 163(j)(7)(B) by cross reference to section 469(c)(7)(C) (*i.e.*, any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business).

¹⁴⁷ Sec. 168(g)(1)(G). An electing farming business is defined in section 163(j)(7)(C), which defines an electing farming business as (i) a farming business as defined in section 263A(e)(4), or (ii) any trade or business of a specified agricultural or horticultural cooperative as defined in section 199A(g)(4) (a clerical correction may be necessary to correct this reference).

¹⁴⁸ Sec. 168(g).

¹⁴⁹ Sec. 168(g)(1)(E) and (g)(7).

¹⁵⁰ Sec. 168(g)(2) and (3).

¹⁵¹ Section 1231 applies to gains and losses on the sale, exchange, or involuntary conversion of certain assets used in the taxpayer’s trade or business. These assets are not capital assets, as that term is generally defined

of gains and losses results in a net gain, then, subject to the depreciation recapture rules, long-term capital gain treatment generally results.¹⁵² If the netting of gains and losses results in a loss, the loss is fully deductible against ordinary income.¹⁵³

The depreciation recapture rules require taxpayers to recognize ordinary income in an amount equal to all or a portion of the gain realized as a result of the disposition of property. The purpose of the rules is to limit a taxpayer's ability to reduce ordinary income via depreciation deductions and then receive capital gain treatment for the portion of any gain on the disposition of the depreciated property that resulted from the taking of depreciation deductions. There are two regimes that dictate depreciation recapture, sections 1245 and 1250.¹⁵⁴ In addition, sections 1245 and 1250 generally override various nonrecognition provisions in the Code.¹⁵⁵

Section 1245

Depreciable personal property, whether tangible or intangible, and certain depreciable real property (typically real property that performs specific functions in a business, but not buildings or structural components of buildings) disposed of at a gain are known as section 1245 property.¹⁵⁶ In addition to depreciation under section 167, the section 1245 recapture rules apply to other cost recovery provisions, including first-year expensing provisions.¹⁵⁷

When a taxpayer disposes of section 1245 property, the taxpayer must (before application of section 1231) recapture the gain on disposition of the property as ordinary income to the

in the Code (see sec. 1221(a)). The assets eligible for this treatment include depreciable property or real property held for more than one year and used in a trade or business (if not includible in inventory, held primarily for sale to customers in the ordinary course of business, or property described in section 1221(a)(3) or (5)). Also included are certain special assets important in particular industries, such as interests in timber, coal, domestic iron ore, certain livestock, and certain unharvested crops.

¹⁵² Sec. 1231(a)(1). However, net section 1231 gain is converted into ordinary income to the extent net section 1231 losses in the previous five years were treated as ordinary losses. Sec. 1231(c). In addition, net gains may be denied capital gains treatment (and taxed as ordinary income) if the transaction is between certain related taxpayers. See sec. 1239.

¹⁵³ Sec. 1231(a)(2).

¹⁵⁴ Cost recovery deductions taken under the Accelerated Cost Recovery System ("ACRS") (for property placed in service after 1980 and before 1987 (before August 31, 1986, if the taxpayer so elected)) generally are subject to recapture; however, properties are not necessarily classified as section 1245 or 1250 property in the same manner as similar properties placed in service before or after ACRS.

¹⁵⁵ See Treas. Reg. secs. 1.1245-6(b) and 1.1250-1(c)(2).

¹⁵⁶ Sec. 1245(a)(3); Treas. Reg. sec. 1.1245-3.

¹⁵⁷ See sec. 1245(a)(2)(C) and (a)(3)(C). For example, any deduction allowed under section 179 is treated as if it were a deduction allowable for a mortization.

extent of earlier depreciation or amortization deductions taken with respect to the asset.¹⁵⁸ Any remaining gain recognized upon the sale of section 1245 property is generally treated as section 1231 gain.

Section 1250

Depreciable real property, other than that included within the definition of section 1245 property, disposed of at a gain is known as section 1250 property.¹⁵⁹ For example, depreciable residential rental property is section 1250 property. Gain on the disposition of section 1250 property is treated as ordinary income, rather than capital gain, only to the extent of the excess depreciation or amortization taken over what would have been available under the straight line method.¹⁶⁰ However, if section 1250 property is held for one year or less, all depreciation is recaptured, regardless of whether it exceeds the depreciation that would have been available under the straight line method. Special rules phase out the recapture for certain types of property held over a specified period of time.¹⁶¹

Since section 1250 recaptures only the excess of accelerated depreciation taken over straight line depreciation and MACRS requires straight line depreciation for nonresidential real property and residential rental property placed in service after 1986, such property placed in service after 1986 generally will not be subject to recapture under section 1250 (except to the extent that section 291(a) applies in the case of a corporation (discussed below)). However, bonus depreciation allowed or allowable with respect to qualified improvement property or land improvements constitutes additional depreciation for purposes of computing section 1250 recapture (*i.e.*, the bonus depreciation deduction is not a straight line method).¹⁶²

For corporations, the amount treated as ordinary income on the disposition of section 1250 property is increased by 20 percent of the additional amount that would be treated as ordinary income if the property were subject to recapture under the rules for section 1245

¹⁵⁸ Sec. 1245(a)(1). Generally, all depreciation or amortization adjustments allowed or allowable must be taken into account. However, if a taxpayer can establish by adequate records or other sufficient evidence that the amount allowed for depreciation or amortization for any period was less than the amount allowable for such period, the taxpayer may take into account only the amount allowed. Treas. Reg. sec. 1.1245-2(a)(7).

¹⁵⁹ Sec. 1250(c); Treas. Reg. sec. 1.1250-1(e).

¹⁶⁰ Sec. 1250(a).

¹⁶¹ Sec. 1250(a)(1)(B). The special phase-out rule applies to residential low-income rental property, certain types of subsidized housing, and property for which rapid depreciation of rehabilitation expenditures was claimed under section 167(k) as in effect on the date before the date of the enactment of the Revenue Reconciliation Act of 1990.

¹⁶² See Treas. Reg. sec. 1.168(k)-2(g)(3). Similarly, in the case of qualified real property (*e.g.*, qualified improvement property) for which the unadjusted basis is reduced by a section 179 deduction, the amount of such reduction is treated as section 1245 property, and the remaining unadjusted basis is treated as section 1250 property. See Notice 2013-59, 2013-40 I.R.B. 297, for special rules for determining the portion of the gain that is attributable to section 1245 property upon the sale or other disposition of qualified real property.

property.¹⁶³ For example, if a corporation sells residential rental property that it held for more than one year, even though the corporation did not claim accelerated depreciation, it is required to recognize ordinary income equal to 20 percent of the lesser of the total amount of depreciation deducted or the gain on the sale. While no separate rate structure exists for corporate capital gains,¹⁶⁴ a corporation may not deduct the amount of capital losses in excess of capital gains for any taxable year. Disallowed capital losses may be carried back three years or carried forward five years.¹⁶⁵

For individuals, estates, and trusts, any capital gain that would be treated as ordinary income if the property were subject to recapture under the rules for section 1245 property is generally taxed at a maximum rate of 25 percent.¹⁶⁶ This is referred to as “unrecaptured section 1250 gain.”¹⁶⁷ The amount of unrecaptured section 1250 gain (before the reduction for the net loss) attributable to the disposition of property to which section 1231 applies may not exceed the net section 1231 gain for the year.¹⁶⁸ Any gain in excess of unrecaptured section 1250 gain is eligible for the 15 percent capital gains rate.¹⁶⁹

¹⁶³ Sec. 291(a)(1).

¹⁶⁴ Income of a corporation is taxed at 21 percent (sec. 11).

¹⁶⁵ Sec. 1212(a).

¹⁶⁶ Sec. 1(h)(1)(E) and (h)(6)(A).

¹⁶⁷ See section 1(h)(6), which defines “unrecaptured 1250 gain” as any long-term capital gain from the sale or exchange of section 1250 property held more than one year to the extent of the gain that would have been treated as ordinary income if section 1250 applied to all depreciation, reduced by the net loss (if any) attributable to the items taken into account in computing 28-percent rate gain of an individual.

¹⁶⁸ Sec. 1(h)(6)(B).

¹⁶⁹ Sec. 1(h)(1)(C).

E. Passive Activity Loss Rules and Special Rental Real Estate Rules

In general

The passive loss rules limit deductions and credits from passive trade or business activities.¹⁷⁰ Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income, such as wages, portfolio income, or business income that is not derived from a passive activity. A similar rule applies to credits. Deductions and credits that are suspended under these rules are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses from a passive activity are allowed in full when a taxpayer disposes of his entire interest in the passive activity in a fully taxable transaction to an unrelated person.

The passive loss rules apply to individuals, estates and trusts, closely held C corporations, and personal service corporations. A special rule permits closely held C corporations to apply passive activity losses and credits against active business income (or tax liability allocable thereto) but not against portfolio income.

Passive activities are defined to include trade or business activities in which the taxpayer does not materially participate. Except as provided in regulations, no interest as a limited partner is treated as an interest with respect to which the taxpayer materially participates.

A passive activity does not include a working interest in any oil or gas property that the taxpayer holds directly or through an entity that does not limit the liability of the taxpayer with respect to the interest. This rule applies without regard to whether the taxpayer materially participates in the activity.

Special rules for rental real estate activities

Rental activities (generally including rental real estate activities) are treated as passive activities, regardless of the level of the taxpayer's participation. However, a special rule treats a taxpayer's rental real estate activities in which he materially participates as not subject to limitation under the passive loss rules if the taxpayer meets eligibility requirements. To be eligible, (1) more than half of the personal services the taxpayer performs in trades or businesses during the taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and (2) the taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.

Another special rule permits the deduction of up to \$25,000 of losses from rental real estate activities in which the taxpayer actively participates. The \$25,000 amount is allowed for taxpayers with adjusted gross incomes of \$100,000 or less and is phased out for taxpayers with adjusted gross incomes between \$100,000 and \$150,000. In the case of any portion of the passive activity credit for any taxable year attributable to the rehabilitation credit, the phase-out

¹⁷⁰ Sec. 469.

begins at \$200,000. The phase-out does not apply to any portion of the passive activity credit for any taxable year which is attributable to the low-income housing credit.¹⁷¹

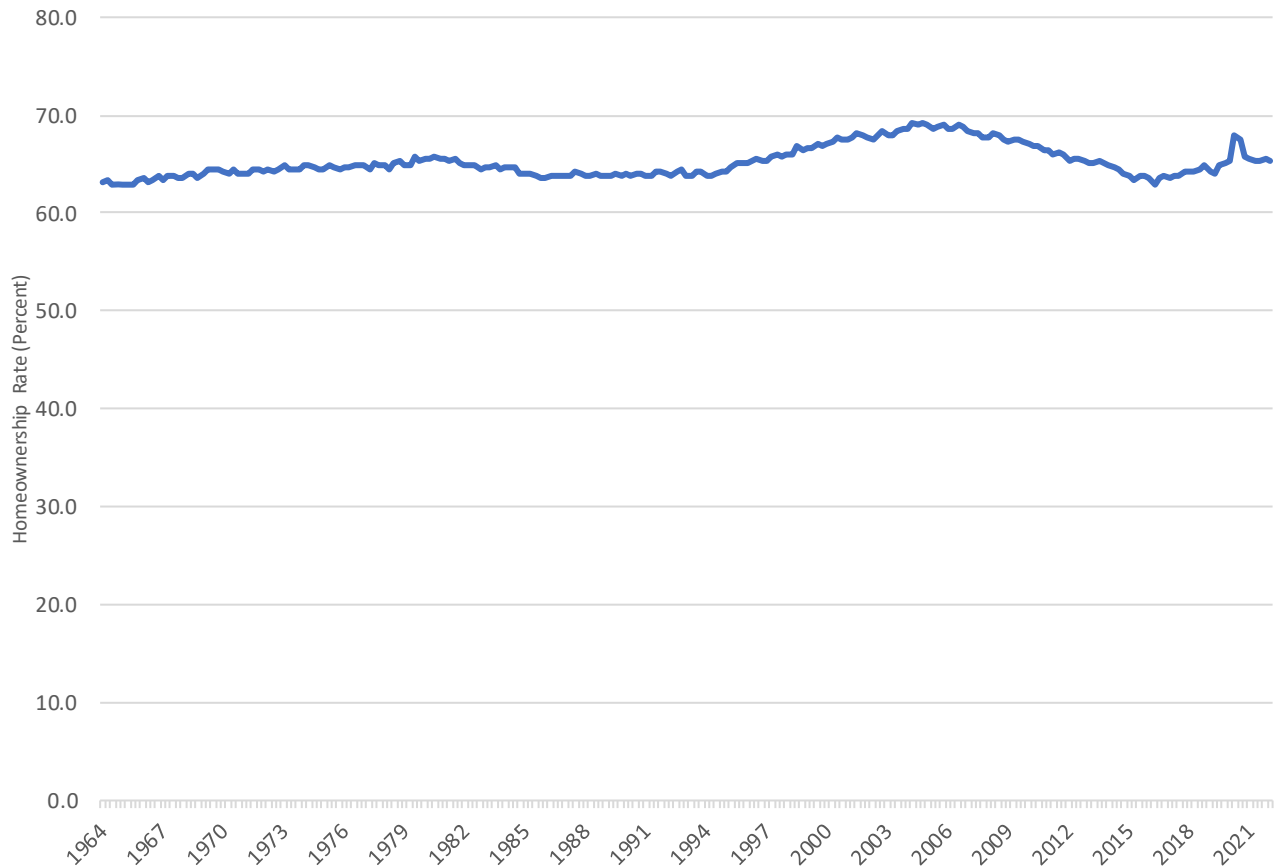
¹⁷¹ Sec. 469(i)(3)(B) and (C).

III. DATA AND ANALYSIS RELATED TO TAX INCENTIVES FOR HOMEOWNERSHIP

In general

Figure 1 shows homeownership rates in the United States by quarter from the first quarter of 1964 through the first quarter of 2022. The homeownership rate is the number of owner-occupied housing units divided by the total number of occupied housing units. The figure shows that over the last half century, the homeownership rate has fluctuated between a low of 62.9 percent in several quarters of 1964 and 1965 to a high of 69.2 percent in two quarters of 2004.¹⁷²

Figure 1.—U.S. Homeownership Rate, 1964-2022, Quarterly



Source: U.S. Census Bureau, Current Population Survey/Housing Vacancy Survey, April 27, 2022.

¹⁷² The Census Bureau notes that data before 1994 and data after 1994 may not be directly comparable, due to the move to a fully computerized survey in 1994. See U.S. Census, Housing Vacancies and Homeownership, First Quarter 2022, Source and Accuracy, for a description of changes to the sampling and methodology over time, including a description of changes in response to the coronavirus pandemic. Available at https://www.census.gov/housing/hvs/files/qtr122/source_22q1.pdf, last visited July 7, 2022.

Certain tax provisions under present law may encourage homeownership. For example, consider the treatment of the unobserved rental value of homeowner's home, or imputed rent. An owner of a rental property, or landlord, is allowed to deduct depreciation, interest on the indebtedness incurred in connection with the property, and other costs. Rent paid to live in the property is includable in income for the landlord and is not deductible as an expense for the tenant. While a homeowner can be thought of as both a landlord and a tenant, homeowners do not include imputed rent in income.¹⁷³ Consequently, the exclusion of imputed rent is a preference for homeowners. An efficient income tax system would tax all income in the same way, implying a tax on imputed rental income, net of interest, taxes, depreciation, and insurance. An alternative approach would be to exclude imputed rental income but deny deductions for mortgage interest, property taxes, depreciation, and insurance.¹⁷⁴ Because under present law homeowners are allowed to deduct mortgage interest and property taxes to determine their taxable income and are not taxed on imputed rental income, but renters are not allowed to deduct rental payments, the current tax system incentivizes taxpayers to buy rather than rent a home, and to finance the acquisition of a home with debt. An exclusion of up to \$500,000 in gross income from capital gain from the sale of a primary residence also reduces the overall cost of homeownership. Additionally, penalty-free withdrawals from tax-advantaged retirement plans increase the liquid funds available for taxpayers to make down payments on homes. These and other tax subsidies that may encourage homeownership (besides the exclusion from imputed rent already described here) are discussed in more detail below.

Economics provides a theoretical framework of “externalities” in the consumption or production of certain goods that may serve as a rationale for government intervention in certain markets, like the market for owner-occupied housing. Externalities exist when, in the consumption or production of a good, there is a difference between the cost (or benefit) to an individual and the cost (or benefit) to society as a whole. These externalities lead to “market failures” wherein the mismatch between individual and social costs (or benefits) results in the purely market-based outcome providing either too little or too much of certain economic activity, relative to what is socially optimal. Thus, in certain settings, tax preferences that encourage increased or decreased consumption or production, as appropriate, can help to achieve an increase in economic efficiency by moving consumption or production toward the socially optimal level.

Proponents of tax incentives for homeownership argue that there are positive externalities to homeownership. Therefore, tax incentives to encourage homeownership may be justified since the social benefits exceed the private benefits of homeownership, and thus in the absence of such incentives the resulting market would have too little homeownership.

At the same time, the presence of positive externalities from homeownership alone may not be sufficient justification for tax incentives for homeownership. Any gains to efficiency due

¹⁷³ The rental value of owner-occupied housing is an important component of the Bureau of Economic Analysis's National Income and Product Accounts which include estimates of gross domestic product (“GDP”). See BEA, *NIPA Handbook: Concepts and Methods of the U.S. National Income and Product Accounts*, updated for 2021.

¹⁷⁴ OECD, *Tax Policy Reform and Economic Growth*, OECD Publishing, 2010, p. 93, available at <http://dx.doi.org/10.1787/9789264091085-en>.

to intervention in the housing market may be offset by losses in efficiency in other markets, for example by distorting taxpayer location decisions, or from higher distortionary taxes unrelated to homeownership to finance the tax incentive for homeownership.

Recognizing that tax incentives for homeownership may be justified in certain situations is just one consideration when determining the appropriate policy. Policymakers may also want to consider the magnitude and form of a subsidy. For example, it is possible to create inefficient outcomes by over-subsidizing a good that produces positive externalities. In addition to providing tax preferences for homeowners, the Federal government assists in the financing of home purchases through other programs. The Federal Housing Administration (“FHA”), the Department of Veterans Affairs (“VA”), and the Department of Agriculture (“USDA”) provide mortgage guarantees¹⁷⁵ and directly provide mortgage loans in certain cases.¹⁷⁶ Government-sponsored enterprises, the Federal National Mortgage Association (“Fannie Mae”) and the Federal Home Loan Mortgage Corporation (“Freddie Mac”), and the Government National Mortgage Association (“Ginnie Mae”) support the secondary market for mortgages by, for example, guaranteeing mortgage loans and issuing or guaranteeing mortgage-backed securities.¹⁷⁷

Therefore, the effectiveness of current tax preferences for owner-occupied housing may be evaluated by assessing whether (1) homeownership generates net positive externalities, (2) tax preferences increase the number of homeowners, and (3) such tax preferences cause unintended distortions.

Empirical evidence of homeownership externalities

Economists have found suggestive evidence for at least three channels through which homeownership generates externalities, both positive and negative.¹⁷⁸ First, there is evidence

¹⁷⁵ For details on Federal mortgage guarantees on loans see https://www.hud.gov/program_offices/housing/fhahistory (FHA), <https://www.benefits.va.gov/homeloans/> (VA), and https://www.rd.usda.gov/sites/default/files/fact-sheet/508_RD_FS_RHS_SFHGLP.pdf (USDA); last visited July 4, 2022.

¹⁷⁶ For details on the USDA’s Section 502 Direct Loan Program see https://www.rd.usda.gov/sites/default/files/fact-sheet/508_RD_FS_RHS_SFH502Direct.pdf, last visited July 4, 2022.

¹⁷⁷ For details see <https://www.fanniemae.com/about-us/what-we-do> (Fannie Mae), <https://www.freddie-mac.com/about> (Freddie Mac), <https://www.ginniemae.gov/about-us/who-we-are/Pages/funding-government-lending.aspx> (Ginnie Mae); last visited July 4, 2022.

¹⁷⁸ See Edward L. Glaeser and Jesse M. Shapiro, “The Benefits of the Home Mortgage Interest Deduction,” in James M. Poterba (ed.), *Tax Policy and the Economy* 17, The MIT Press, 2003, pp. 37-82 for a review of the literature on externalities. See also N. Edward Coulson and Herman Li, “Measuring the External Benefits of Homeownership,” *Journal of Urban Economics*, vol. 77, September 2013, pp. 57-67.

that homeowners maintain their homes better than renters (or landlords).¹⁷⁹ This may yield aesthetic benefits to others and may foster other desirable neighborhood characteristics, such as lower crime. Second, the fact that the value of a home is often closely linked to the strength of the community may encourage homeowners, more than renters, to support long-term community investments.¹⁸⁰ The incentive to raise house prices, however, might also lead homeowners to restrict the supply of new homes artificially through land use regulation.¹⁸¹ Third, homeownership has been found to reduce residential mobility.¹⁸² Reduced mobility may provide owners with a longer time horizon over which to evaluate community investments (whether through involvement in local civic organizations or investments in local government goods and services). Neighborhood stability may also be associated with lower crime.¹⁸³ Reduced mobility, however, may have negative consequences for the labor market if it prevents people from moving for jobs for which they may be better suited or encourages them to accept jobs for which they may be relatively poorly matched.¹⁸⁴

Tax subsidies for homeownership

Mortgage interest deduction

The deduction for home mortgage interest reduces the after-tax cost of financing and maintaining a home for taxpayers that itemize deductions. As a result of changes to the Code made in the 2017 Tax Act,¹⁸⁵ namely the increase in the standard deduction and the changes to

¹⁷⁹ George Galster, "Empirical Evidence on Cross-Tenure Differences in House Maintenance and Conditions," *Land Economics*, vol. 59, February 1983, pp. 107-113. John Harding, Thomas J. Miceli, and C. F. Sirmans, "Do Owners Take Better Care of Their Housing Than Renters?," *Real Estate Economics*, vol. 28, December 2000, pp. 663-681. Denise DiPasquale and Edward L. Glaeser, "Incentives and Social Capital: Are Homeowners Better Citizens?," *Journal of Urban Economics*, vol. 45, March 1999, pp. 354-384.

¹⁸⁰ Renters may actually be worse off if property values and rents rise disproportionately to the direct benefits renters receive from these investments.

¹⁸¹ Edward L. Glaeser and Jesse M. Shapiro, "The Benefits of the Home Mortgage Interest Deduction," in James M. Poterba (ed.), *Tax Policy and the Economy 17*, The MIT Press, 2003, p. 69.

¹⁸² Fernando Ferreira, Joseph Gyourko, and Joseph Tracy, "Housing Busts and Household Mobility," *Journal of Urban Economics*, vol. 68, July 2010, pp. 34-45. Andrew Henley, "Residential Mobility, Housing Equity, and the Labour Market," *Economic Journal*, vol. 108, March 1998, pp. 414-427.

¹⁸³ Charis E. Kubrin, "Structural Covariates of Homicide Rates: Does Type of Homicide Matter?," *Journal of Research in Crime and Delinquency*, vol. 40(2), 2003, pp. 139-170. Lauren J. Krivo and Ruth D. Peterson, "The Structural Context of Homicide: Accounting for Racial Differences in Process," *American Sociological Review*, vol. 65(4), 2000, pp. 547-559. For contrary findings, see Corina Graif and Robert J. Sampson, "Spatial Heterogeneity in the Effects of Immigration and Diversity on Neighborhood Homicide Rates," *Homicide Studies*, vol. 13(3), 2009, pp. 242-260 and Robert J. Sampson, Stephen W. Raudenbush, and Felton Earls, "Neighborhoods and Violent Crime: A Multilevel Study of Collective Efficacy," *Science*, vol. 277, August 1997, pp. 918-924.

¹⁸⁴ Richard K. Green and Patric H. Hendershott, "Home-ownership and Unemployment in the US," *Urban Studies*, vol. 38(9), 2001, pp. 1509-1520.

¹⁸⁵ Pub. L. No. 115-97.

itemized deductions (such as the temporary \$10,000 limitation on State and local tax deductions and the suspension of miscellaneous itemized deductions), the optimal decision for more taxpayers is to claim the standard deduction, rather than to claim itemized deductions.¹⁸⁶ Therefore, fewer taxpayers claim, or are incentivized by, the mortgage interest deduction. The Joint Committee staff estimates that for the 2022 tax year approximately 12 percent of taxpayers will itemize deductions (compared to 32 percent for 2017).

Itemizers, and specifically taxpayers who claim the mortgage interest itemized deduction, tend to be higher in the income distribution. This is especially the case after the enactment of the 2017 Tax Act. Because marginal tax rates increase with income, the average tax savings from the mortgage interest deduction increases as annual household income increases. Table 1, below, shows this pattern for the mortgage interest deduction.

**Table 1.—Distribution of Mortgage Interest Deduction, 2022
(Projected)**

Income Category [1]	All Taxpayers		Taxpayers Claiming Mortgage Interest Deduction	
	Returns [2] (Thousands)	Income (\$ Millions)	Returns (Thousands)	Amount (\$ Millions)
Less than \$10,000.....	14,414	48,406	42	480
\$10,000 to \$20,000.....	14,475	221,312	79	1,111
\$20,000 to \$30,000.....	17,136	429,708	106	1,150
\$30,000 to \$40,000.....	16,923	590,258	168	1,748
\$40,000 to \$50,000.....	14,814	665,671	260	2,627
\$50,000 to \$75,000.....	29,814	1,840,380	1,064	9,884
\$75,000 to \$100,000.....	19,000	1,648,614	1,474	14,241
\$100,000 to \$200,000.....	35,778	4,992,800	5,182	59,024
\$200,000 to \$500,000.....	14,329	4,044,418	4,413	71,673
\$500,000 to \$1,000,000.....	1,836	1,234,690	909	19,185
\$1,000,000 and over.....	917	3,026,866	507	11,977
Total, All Taxpayers.....	179,437	18,743,122	14,204	193,100

[1] The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus:

(1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) employer share of FICA tax, (4) workers' compensation, (5) nontaxable Social Security benefits, (6) insurance value of Medicare benefits, (7) alternative minimum tax preference items, (8) individual share of business taxes, and (9) excluded income of U.S. citizens living abroad. Categories are measured at 2022 levels.

[2] Includes nonfilers, excludes dependent filers and returns with negative income.

Source: Joint Committee on Taxation staff estimates.

Studies that compare the mortgage interest deduction and homeownership rates over time within the United States and across countries generally provide no strong evidence of a relationship between the two.¹⁸⁷ Recent empirical work finds that the mortgage interest deduction may influence homeownership on the “intensive margin,” that is, it may cause

¹⁸⁶ For 2022 the amount of the standard deduction is \$12,950 for a single individual and for a married individual filing separately, \$19,400 for a head of household, and \$25,900 for married individuals filing jointly and for a surviving spouse.

¹⁸⁷ Edward L. Glaeser and Jesse M. Shapiro, “The benefits of the home mortgage interest deduction,” *Tax policy and the economy*, vol 17, 2003, pp. 37-82. Roberta F. Mann, “The (Not So) Little House on the Prairie: The Hidden Costs of the Home Mortgage Interest Deduction,” *Arizona State Law Journal*, vol. 32, 2000, pp. 1347-1396.

borrowers to purchase larger and more expensive homes and increase the level of debt financing, but does not have an effect on the “extensive margin,” that is, it has little to no effect on the decision of whether to purchase a home.¹⁸⁸ Other research that does find some evidence of a meaningful effect of the mortgage interest deduction on homeownership rates finds the effect only in markets where positive externalities from homeownership are less likely to exist.¹⁸⁹

Deduction for real property taxes

Similar to the deduction for home mortgage interest, the deduction for real property taxes reduces the after-tax cost of financing and maintaining a home for taxpayers that itemize deductions. Because the deduction for real property taxes is an itemized deduction, the benefit of the deduction tends to accrue to taxpayers in the higher end of the income distribution, similar to the deduction for home mortgage interest. Table 2, below, shows this pattern for the deduction for State and local taxes (which include property taxes). The temporary \$10,000 aggregate limitation on State and local real property, personal property, and income (or sales) tax for the deduction further restricts the set of taxpayers that may be incentivized and benefit from the deduction.¹⁹⁰

¹⁸⁸ Jonathan Gruber, Amalie Jensen, and Henrik Kleven, “Do People Respond to the Mortgage Interest Deduction? Quasi-Experimental Evidence from Denmark,” *American Economic Journal: Economic Policy*, vol. 13(2), pp. 273-303.

¹⁸⁹ See Christian A. L. Hilber and Tracy M. Turner, “The Mortgage Interest Deduction and its Impact on Homeownership Decisions,” *The Review of Economics and Statistics*, MIT Press, vol. 96(4), 2014, pp. 618-637. The authors find a positive effect of the mortgage interest deduction among higher-income groups in elastically supplied housing markets, that is, places with lax land use rules and room to build new homes, but argue that positive externalities related to homeownership are likely confined to places with inelastic housing supply, typically densely populated areas with tight regulation, where investment in local public goods is capitalized into local house prices.

¹⁹⁰ For example, a taxpayer with \$10,000 in State income or sales taxes would receive the same deduction as a taxpayer with \$10,000 in State income or sales taxes and \$5,000 in real property taxes.

**Table 2.—Distribution of State and Local Tax Deduction, 2022
(Projected)**

Income Category [1]	All Taxpayers		Taxpayers Claiming State and Local Tax Deduction	
	Returns [2] (Thousands)	Income (\$ Millions)	Returns (Thousands)	Amount (\$ Millions)
Less than \$10,000.....	14,414	48,406	112	349
\$10,000 to \$20,000.....	14,475	221,312	131	607
\$20,000 to \$30,000.....	17,136	429,708	200	897
\$30,000 to \$40,000.....	16,923	590,258	329	1,452
\$40,000 to \$50,000.....	14,814	665,671	472	2,524
\$50,000 to \$75,000.....	29,814	1,840,380	1,654	9,525
\$75,000 to \$100,000.....	19,000	1,648,614	1,982	13,404
\$100,000 to \$200,000.....	35,778	4,992,800	6,371	53,459
\$200,000 to \$500,000.....	14,329	4,044,418	5,049	48,558
\$500,000 to \$1,000,000.....	1,836	1,234,690	1,075	10,734
\$1,000,000 and over.....	917	3,026,866	689	7,035
Total, All Taxpayers.....	179,437	18,743,122	18,064	148,544

[1] The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus:

(1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) employer share of FICA tax, (4) workers' compensation, (5) nontaxable Social Security benefits, (6) insurance value of Medicare benefits, (7) alternative minimum tax preference items, (8) individual share of business taxes, and (9) excluded income of U.S. citizens living abroad. Categories are measured at 2022 levels.

[2] Includes nonfilers, excludes dependent filers and returns with negative income.

Source: Joint Committee on Taxation staff estimates.

Proponents and critics of the State and local tax deduction generally focus on issues other than the effects of the deduction on homeownership, such as whether the deduction allows for a more appropriate measure taxpayer's ability to pay taxes or whether the taxes should be regarded as payments for State and local services.¹⁹¹ Generally, research on the effects of the State and local tax deduction finds that States and localities alter the composition of State and local revenue collection toward Federally deductible taxes.¹⁹² This suggests that property taxes may be higher than in the absence of the deduction, muting the incentive benefit of the deduction.

Capital gains exclusion for primary residence

Generally, taxpayers do not include an item of gain or loss in gross income until they realize a gain or loss. Under present law, with respect to property, realization generally occurs when the taxpayer sells, exchanges, or otherwise disposes of the asset on which the gain or loss has accrued. However, an exclusion for gains up to \$500,000 from the sale of certain principal

¹⁹¹ See Joint Committee on Taxation, *Background on the Itemized Deduction for State and Local Taxes* (JCX-35-19), June 24, 2019.

¹⁹² Bradley T. Heim and Yulianti Abbas, "Does Federal Deductibility Affect State and Local Revenue Sources?," *National Tax Journal*, March 2015, pp. 33-58. Mary N. Gade and Lee C. Adkins, "Tax Exporting and State Revenue Structures," *National Tax Journal*, March 1990, pp. 39-52. Martin S. Feldstein and Gilbert E. Metcalf, "The Effect of Federal Tax Deductibility on State and Local Taxes and Spending," *Journal of Political Economy*, August 1987, pp. 710-736.

residences is allowed, which reduces the cost of homeownership for taxpayers with homes that increase in price.

Table 3 shows the Joint Committee staff's estimates of the exclusion of capital gains on sales of principal residences from 2014 to 2020.¹⁹³ Over this period, nominal housing prices increased by approximately 41 percent.¹⁹⁴

Table 3.—Tax Expenditure Estimates of the Exclusion of Capital Gains on Sales of Principal Residences, 2014-2020

Fiscal Year	Exclusion of Capital Gains on Sale of Principal Residence (\$ Billions)
2014	24.1
2015	24.1
2016	29.2
2017	32.9
2018	34.6
2019	34.7
2020	34.5

Source: Joint Committee on Taxation staff estimates.

Besides an incentive for homeownership, another rationale for a capital gains exclusion for primary residences is to promote labor mobility. Since unrealized capital gains, including on homes, is deferred until realization, selling as a realization event may incur a substantial tax cost, reducing the incentive to move which is sometimes described as a “lock-in effect.”

Empirical research on the effect of the capital gains exclusion for primary residences has found that reductions in capital gains taxes increased home sale rates¹⁹⁵ and the mobility of

¹⁹³ These values are not adjusted for inflation.

¹⁹⁴ The change in housing price is calculated using the quarterly all-transactions house price index produced by the Federal Housing Finance Agency. This index measures the movement of single family homes taking into account purchase and appraisal data.

¹⁹⁵ Hui Shan, “The effect of capital gains taxation on home sales: Evidence from the Taxpayer Relief Act of 1997,” *Journal of Public Economics*, 2011, pp. 177-188. The author finds that changes to the capital gains treatment of homes enacted by Pub. L. No. 105-34, the “Taxpayer Relief Act of 1997,” increased the semiannual sales rate of houses with gains up to \$500,000 but finds no evidence of change for houses with gains above

households.¹⁹⁶ This evidence supports the theory of a lock-in effect created by capital gains taxation of sales of primary residences. Some have proposed eliminating or indexing the limitation on the exclusion to alleviate mobility distortions.¹⁹⁷

However, assets held until death may avoid tax through step-up basis, since an heir's basis is "stepped up" to the fair market value of the asset on the date of the decedent's death. For those taxpayers with gains exceeding any exclusion thresholds, the interaction with step-up basis at death may create a further lock-in effect as property held until death may be passed to heirs without incurring any Federal income tax. Another proposal would equalize treatment between current sales and transfers at death by eliminating step-up basis at death.

Exclusion from income of certain housing allowances and related deductions

The exclusion from income for the rental value of parsonages and the military basic allowance for housing may also incentivize home ownership for the members of the clergy and the military. These housing allowances are part of compensation. In general, compensation is deductible by the payor and includable in income of the payee. This exclusion allows compensation in the form of housing allowances to be excluded from income of certain taxpayers, creating an incentive to provide compensation in the form of housing allowances rather than other forms of compensation that are includable in income, such as wages. This exclusion is available whether the individual owns or rents a home. Moreover, in the case of a homeowner, no otherwise allowable deduction for mortgage interest or real property taxes is denied, notwithstanding the general rule that deductions related to tax-exempt income are not permitted. Thus, the taxpayer is permitted these deductions even though the income used to acquire the home and the imputed rental income from the owner-occupied housing are both excluded from income. This makes it more attractive to use these benefits to own rather than rent a home.

Taxation of income from the discharge of indebtedness

Taxation of income from the discharge of indebtedness may affect the incentives of households to borrow. In principle, taxation of this income reduces the net benefit of filing for bankruptcy and reduces incentives to borrow. It follows then that the exclusion of qualified principal residence indebtedness from Federal income taxation reduces the cost of borrowing and therefore increases the incentives to borrow to purchase a home.

\$500,000. The author uses subsequent changes in the capital gains tax rates to estimate a tax elasticity of home sales and finds increases in capital gains reduce semiannual home sales rates.

¹⁹⁶ Christopher R. Cunningham and Gary V. Englehardt, "Housing capital-gains taxation and homeowner mobility: evidence from the Taxpayer Relief Act of 1997." *Journal of Urban Economics*, vol 63, no. 3, 2008, pp. 803-815. The authors find that the changes to the capital gains treatment of homes enacted by the Taxpayer Relief Act of 1997 increased residential mobility for homeowners just under 55, who under prior law were not able to claim an exclusion for capital gains from a home.

¹⁹⁷ Gerald Auten and Jane G. Gravelle, "The exclusion of capital gains on the sale of principal residences: Policy options," *Proceedings. Annual Conference of the National Tax Association*, vol. 102, 2009, pp. 103-112.

Researchers are divided on the main causes of bankruptcy filings. Some studies claim that bankruptcy filings are primarily the result of adverse events (such as sickness, accidents, unemployment, divorce). Others claim that consumption patterns play a larger role. Some research finds that both may be strong contributors to bankruptcy.¹⁹⁸ If consumption patterns play an important role in households' decisions to file for bankruptcy, these filings may be strategic. That is, households may weigh costs and benefits in their decision to file. Furthermore, the availability of the option to file for bankruptcy can change households' consumption patterns if households are more likely to consume knowing they bear less than the full cost of consumption in the event of bankruptcy. Some research shows households do indeed behave strategically, filing for bankruptcy when the benefits of filing (for example, discharge of indebtedness) exceed the costs of filing (for example, forfeiture of assets).¹⁹⁹ Taxation of indebtedness income reduces incentives to borrow by reducing the net benefit of filing for bankruptcy. If adverse events are primarily responsible for bankruptcy filings, these incentives may have a smaller effect on actual borrowing. On the other hand, if consumption patterns are primarily responsible for bankruptcy filings, these incentives may have a larger effect on actual borrowing.

Special rules for distributions from IRAs and plan loans

The exception from the 10-percent early withdrawal tax for qualified first-time homebuyer distributions from certain traditional and Roth IRAs may decrease the overall cost of financing home purchases and therefore increase incentives for individuals to purchase a home. Similarly, certain special rules for loan proceeds used to purchase a principal residence allow individuals to access retirement funds for this purpose, thereby increasing incentives to purchase a home.

¹⁹⁸ Ian Domowitz and Robert L. Sartin, "Determinants of the consumer bankruptcy decision," *The Journal of Finance* vol 54(1), 1999, pp. 403-420, find that both medical and credit card debt are strong contributors to bankruptcy,

¹⁹⁹ Scott Fay, Eric Hurst, and Michelle White, "The Household Bankruptcy Decision," *American Economics Review*, 92, 2002, pp. 706-178.

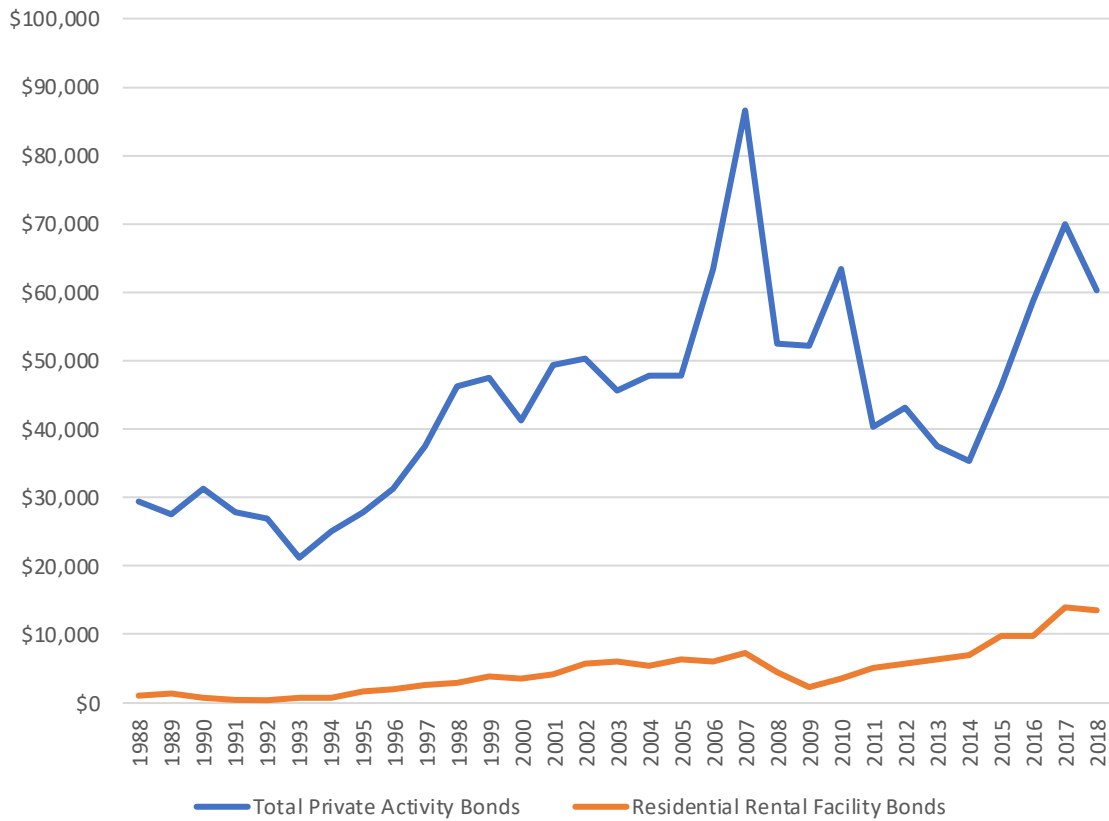
IV. DATA AND ANALYSIS RELATED TO TAX INCENTIVES FOR RENTAL HOUSING

Qualified private activity bonds

Gross income for Federal income tax purposes generally does not include interest paid on State or local qualified private activity bonds, including qualified private activity bonds issued to finance residential rental property. Figure 2 shows the volume of new money issuances of long-term private activity bonds in total and the volume of residential rental bonds since 1988 as reported to the IRS on Form 8038. For 2018, \$13.7 billion of qualified residential rental bonds for residential rental property were issued. Qualified residential rental facility bonds ranged from 1.5 percent to 22.6 percent of all new money issuances of qualified private activity bonds in each year from 1988 through 2018; the average for a single year in that period was 9.7 percent. By contrast, for 2018, \$6.6 billion of qualified mortgage bonds were issued to finance owner-occupied housing, representing 10.9 percent of all new money issuances of qualified private activity bonds in that year.²⁰⁰

²⁰⁰ IRS SOI Tax-Exempt Bond Statistics, 2018. Available at <https://www.irs.gov/statistics/soi-tax-stats-tax-exempt-bond-statistics>.

**Figure 2.—Long-term Tax-Exempt Private Activity Bonds,
New Money Issuances, 1988-2018
(Millions of Dollars)**



Source: IRS Statistics of Income, various years.

The qualified residential rental bond program allows States to issue tax-exempt bonds to finance residential rental property. Because the interest on these bonds is excluded from gross income for Federal income tax purposes, and in some cases for State income tax purposes, investors are generally willing to accept a lower interest rate on these bonds than they might otherwise accept on a taxable investment, all else being equal. This, in turn, lowers the borrowing cost for the beneficiaries of such financing. Some of the benefits, however, may accrue to bond investors in higher marginal tax brackets in the form of higher after-tax returns rather than to borrowers in the form of reduced interest costs or renters in the form of lower rents.²⁰¹

²⁰¹ For a discussion of economic issues relating to tax-exempt bond financing and a table showing historical implied marginal tax rates for the marginal investor, see Joint Committee on Taxation, *Present Law and Background Information Related to Federal Taxation and State and Local Government Finance* (JCX-7-13), March 15, 2013, pp. 50-56. See Joint Committee on Taxation, *The Federal Revenue Effects of Tax-Exempt and Direct-Pay Tax Credit Bond Provisions* (JCX-60-12), July 16, 2012, for a description of the economic modeling that the Joint Committee staff undertakes to assess the Federal revenue effects of tax-exempt bond provisions.

Furthermore, if the market-clearing purchaser of municipal bonds is likely to be in a higher income tax bracket than other bondholders, the loss of Federal tax receipts may be greater than the reduction in the interest cost of tax-exempt issuers. For example, consider a taxpayer with a 25-percent marginal tax rate who purchases a \$1,000 taxable bond that pays 6 percent interest. This investor receives \$60 in interest income and pays \$15 in income tax, for an after-tax return of \$45 and an after-tax yield of 4.5 percent. That return is the same as the return the taxpayer receives on a hypothetical \$1,000 tax-exempt bond that pays 4.5 percent interest. In this scenario, the investor with the 25-percent marginal tax rate is indifferent between the taxable bond that pays 6 percent interest and the tax-exempt bond that pays 4.5 percent interest.

Now suppose a taxpayer with a 33-percent marginal tax rate purchases a \$1,000 taxable bond that pays 6 percent interest. This investor receives \$60 in interest income and pays \$20 in income tax for an after-tax return of \$40 and an after-tax yield of four percent. This investor prefers the hypothetical tax-exempt bond that pays 4.5 percent interest. Thus, unlike the investor in the 25-percent tax bracket who is indifferent to investment in either taxable or tax-exempt bonds, the bond investor in the 33-percent marginal tax bracket receives a benefit by purchasing the tax-exempt bond. In contrast, a bond investor with a 15-percent marginal tax rate receives no benefit from purchasing the tax-exempt bond, and in fact would have a lower after-tax return on the tax-exempt bond than on the purchase of a taxable bond paying six percent interest.

In the example above, the taxpayer with the 33-percent marginal tax rate is indifferent between the taxable bond and a hypothetical tax-exempt bond that pays four percent interest. In this scenario, a purchase of tax-exempt bonds that pays 4.5 percent interest results in a tax savings to the purchaser that is \$5 greater than the tax savings with a tax-exempt bond paying four percent interest. That is, there is a reduction in Federal tax receipts of \$5 more than the reduction in the interest cost of the tax-exempt issuer.

Low-income housing credit

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 credit amount is determined such that the present value of the credits over a 10-year period is equal to 70 percent or 30 percent of a building's qualified basis. Such credits are sometimes referred to as "nine-percent credits" and "four-percent credits," respectively. (Further details on credit calculations are available in section II.A. of this document, "Low-income Housing Tax Credit.")

Table 4 reports the allocations of nine-percent credits and four-percent credits from 2001 through 2021. The effect of temporary legislative changes, including an increase in the State housing credit allocations for the nine-percent credit, and a decline in the bond market, which affects the usage of four-percent credits, is evident in 2009. Having represented about three-quarters of all credit allocations on average in prior years, the nine-percent credits represent over 90 percent of all allocations in 2009, before returning to the historical share by 2011.

**Table 4.—Low-Income Housing Credit Allocations
(millions of dollars)**

Year	9 Percent Credits	4 Percent Credits
2001	462.3	137.2
2002	517.2	201.7
2003	573.6	215.2
2004	606.0	216.4
2005	586.5	246.1
2006	730.8	256.0
2007	790.6	315.2
2008	939.9	335.0
2009	1,136.2	93.6
2010	917.4	186.9
2011	749.7	228.3
2012	754.7	196.8
2013	759.9	215.8
2014	775.8	208.9
2015	792.7	297.1
2016	776.4	319.1
2017	916.4	361.0
2018	1,019.9	419.2
2019	1,129.2	501.0
2020	1,120.9	718.3
2021	1,330.1	663.2

Source: State Housing Finance Agencies Factbook: NCHSA Annual Survey Results, Years 2001-2021.

Table 5 reports low-income housing tax credits claimed by corporations²⁰² on Form 3800 (relating to general business credits) between 2009 and 2019.²⁰³ The majority of investors are financial institutions and banks, partly due to various considerations these investments receive in examinations under the Community Reinvestment Act (“CRA”).²⁰⁴ Credits claimed by corporations increased steadily through the period and reached a peak of nearly \$10.3 billion in 2019.

**Table 5.—Low-Income Housing Tax Credits Claimed by Corporations
(millions of dollars)**

Year	Credits Claimed
2009	6,730.00
2010	7,035.10
2011	7,083.90
2012	8,092.50
2013	8,485.60
2014	8,895.90
2015	*
2016	9,397.20
2017	9,581.30
2018	9,887.13
2019	10,258.79

* Data are unavailable.

Source: IRS Statistics of Income Corporate Files, various years.

²⁰² In addition to the credits claimed by corporations, a small amount of low-income housing tax credits is claimed by individuals. These amounts are not included in the table.

²⁰³ The amounts reported do not reflect the actual tax reduction achieved by taxpayers claiming low-income housing tax credits, as the actual tax reduction depends upon whether the taxpayer had operating losses, is subject to the alternative minimum tax, and other aspects specific to each taxpayer’s situation.

²⁰⁴ Mark P. Keightley, *An Introduction to the Low-Income Housing Tax Credit* (Report RS22389), June 23, 2022, p. 6, available at <https://sgp.fas.org/crs/misc/RS22389.pdf>. For more information on the LIHTC program and the CRA, see Office of the Comptroller of the Currency, *Low-Income Housing tax Credits: Affordable Housing Investment Opportunities for Banks*, Washington DC, April 2014, <https://www OCC.gov/publications-and-resources/publications/community-affairs/community-developments-insights/ca-insights-mar-2014.html>.

Rehabilitation tax credit

Table 6 reports the total amount of rehabilitation tax credits claimed by corporations²⁰⁵ in 2019.²⁰⁶ The data represent claims by corporations for both the credit for certified historic structures and the credit for pre-1936 buildings other than historic structures. These data may not be comparable to data prior to 2018 due to changes in law since 2018. For more on these changes and a discussion of present law, see section II.B. of this document, “Rehabilitation Tax Credit.”

**Table 6.—Rehabilitation Tax Credits Claimed by Corporations, 2019
(thousands of dollars)**

Pre-1936 buildings¹	Certified historic structures	Total
13,517	1,009,892	1,023,409

¹ This data represents pre-1936 buildings as allowed under rules prior to 2018.
Source: IRS Statistics of Income, 2022.

Tax expenditure estimates

Table 7 contains tax expenditure estimates for select tax provisions related to rental housing.²⁰⁷ Estimates are shown for the total tax expenditure for fiscal years 2020-2024.²⁰⁸ The largest tax expenditure related to rental housing is the credit for low-income housing, with a tax expenditure estimate of \$54.6 billion. Approximately \$52.4 billion of the \$54.6 billion is attributable to corporations. The next largest item, accelerated depreciation of rental housing, is available regardless of the income of the tenant. The estimated tax expenditure is about half as large at \$27.5 billion, while the exclusion of interest on State and local government qualified private activity bonds for rental housing is \$4.7 billion. In contrast to the low-income housing

²⁰⁵ In addition to the credits claimed by corporations, a small amount of rehabilitation tax credits is claimed by individuals. These amounts are not included in the table.

²⁰⁶ The amounts reported do not reflect the actual tax reduction achieved by taxpayers claiming rehabilitation tax credits, as the actual tax reduction depends upon whether the taxpayer has operating losses, is subject to the alternative minimum tax, and other factors specific to the taxpayer’s situation.

²⁰⁷ A tax expenditure estimate is not the same as a revenue estimate for the repeal of the tax expenditure provision. First, unlike revenue estimates, tax expenditure estimates do not incorporate the effects of the behavioral changes that are anticipated to occur in response to the repeal of a tax expenditure provision, other than simple additions or deletions in filing tax forms, or what the Joint Committee staff refers to as “tax form behavior.” Second, tax expenditure calculations are concerned with changes in the reported tax liabilities of taxpayers without concern for the short-term timing of tax payments, whereas revenue estimates are concerned with changes in Federal government tax receipts that are affected by the timing of all tax payments. Third, tax expenditure estimates reflect only the income tax effects of provisions. A revenue estimate would consider interactions between the income tax and other Federal taxes such as payroll, excise, and the estate and gift taxes.

²⁰⁸ Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2020-2024* (JCX-23-20), November 5, 2020.

tax credit, most of the tax expenditure for these provisions (\$23.4 billion, and \$3.9 billion, respectively) is attributable to individuals.

**Table 7.—Select Tax Expenditures for Housing,
Fiscal Years 2020-2024**

Tax Expenditure	Total Amount (billions of dollars)
Credit for low-income housing	54.6
Depreciation of rental housing in excess of alternative depreciation system	27.5
Exclusion of interest on State and local government qualified private activity bonds for rental housing	4.7

Source: Joint Committee on Taxation staff.