Section 8

General Explanation of the
Tax Reform Act of 1986

[JOINT COMMITTEE PRINT]

GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986

(H.R. 3838, 99TH CONGRESS; PUBLIC LAW 99-514)

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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SUMMARY CONTENTS

	Page
Letter of Transmittal	XVII
I. Legislative Background of the Act	1
II. General Reasons for the Act	6
III. General Explanation of the Act	12
Title I. Individual Income Tax Provisions	12
Title II. Capital Cost Provisions	89
Title III. Capital Gains and Losses	178
Title IV. Agriculture, Natural Resources, and Energy	187
Title V. Tax Shelters; Interest Expense	209
Title VI. Corporate Taxation	271
Title VII. Minimum Tax Provisions	429
Title VIII. Accounting Provisions	474
Title IX. Financial Institutions	549
Title X. Insurance Products and Companies	575
Title XI. Pensions and Deferred Compensation; Employee Benefits; ESOPs	624
Title XII. Foreign Tax Provisions	852
Title XIII. Tax-Exempt Bonds	1128
Title XIV. Trusts and Estates; Minor Children; Gift and Estate Taxes; Generation Skipping Transfer Tax	1243
Title XV. Compliance and Tax Administration	1269
Title XVI. Exempt and Nonprofit Organizations	1324
Title XVII. Miscellaneous Provisions	1333
Appendix: Estimated Revenue Effects of the Act	1353

Property that qualifies for transitional relief from the amendments relating to the rehabilitation tax credit is also excepted from the depreciation changes made by section 201 of the Act.

Revenue Effect

This provision is estimated to increase fiscal year budget receipts by $43 million in 1987, $165 million in 1988, $581 million in 1989, $1,371 million in 1990, and $1,779 million in 1991.

2. Tax credit for low-income rental housing (sec. 252 of the Act and sec. 42 of the Code)[1]

Prior Law

No low-income rental housing tax credit was provided under prior law, but other tax incentives for low-income housing were available. These tax incentives consisted principally of special accelerated depreciation, five-year amortization of rehabilitation expenses, expensing of construction period interest and taxes, and tax-exempt bond financing for multifamily residential rental property.

Reasons for Change

Congress was concerned that the tax preferences for low-income rental housing available under prior law were not effective in providing affordable housing for low-income individuals. Congress believed a more efficient mechanism for encouraging the production of low-income rental housing could be provided through the low-income rental housing tax credit.

The primary tax preferences provided for low-income housing under prior law were tax-exempt bond financing, accelerated cost recovery deductions, five-year amortization of rehabilitation expenditures, and special deductions for construction period interest and taxes. These preferences operated in an uncoordinated manner, resulted in subsidies unrelated to the number of low-income individuals served, and failed to guarantee that affordable housing would be provided to the most needy low-income individuals.

A major shortcoming of the prior-law tax subsidies was that, beyond a minimum threshold requirement of low-income housing units that were required to be served, the degree of subsidy was not directly linked to the number of units serving low-income persons. As a result, there was no incentive to provide low-income units beyond the minimum required. Under the tax credit, however, the amount of the low-income housing tax credit which an owner may receive is directly related to the number of rental units made available to low-income individuals. By providing tax credits which are based on the number of units serving low-income persons, an incen-

[1] For legislative background of the provision, see: H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 1413; S.Rep. 99-313, pp. 757-768; Senate floor amendment, 132 Cong. Rec. S8146-8158 (June 23, 1986); and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 85-103 (Conference Report).

tive exists to provide a greater number of housing units for more low-income individuals.

Another weakness of the Federal tax subsidies available under prior law was that they were not targeted to persons of truly low-income. For example, a study by the General Accounting Office[2] (GAO) of tax-exempt bond financed residential rental projects found that above-average income renters could qualify under prior law as "low" or "moderate" income for two reasons. First, persons with incomes as high as 80 percent of area median income were eligible to occupy units reserved for low- and moderate-income tenants. This income ceiling was relatively high, particularly when compared with the median income of renters. Second, the Treasury Department did not require household incomes to be adjusted for family size until after 1985. Congress believed that the low-income housing tax credit (as well as tax-exempt bond financing for low-income housing, discussed in Title XIII) should be provided only for households with incomes not exceeding 50 percent or 60 percent of area median income. Congress further believed that these income limits should be adjusted for family size. These provisions better target affordable housing to those persons most in need of assistance.

Another shortcoming of the tax subsidies under prior law was that none limited the rents that could be charged to low-income individuals. The same GAO study found, for example, that while 96 percent of individuals with incomes over 80 percent of area median income (the prior-law ceiling on "low" or "moderate" income) paid rents of less than 30 percent of their income, only 37 percent of individuals with incomes below 80 percent of area median paid rents of less than 30 percent of their income. The low-income housing tax credit limits the rent that may be charged to a low-income tenant, and therefore ensures that the subsidized housing is affordable to low-income individuals. In return for providing housing at reduced rents, owners of rental housing receive a tax credit designed to compensate them for the rent reduction.

Congress believed that the low-income housing tax credit (and tax-exempt bonds, as retargeted) will more effectively serve both low-income individuals and owners willing to provide affordable low-income housing than the multiple, uncoordinated tax preferences for low-income housing under prior law.

Explanation of Provisions

Overview

The Act provides a tax credit that may be claimed by owners of residential rental property used for low-income housing. The credit is claimed annually, generally for a period of ten years. New construction and rehabilitation expenditures for low-income housing projects placed in service in 1987 are eligible for a maximum nine percent credit, paid annually for ten years. The acquisition cost of existing projects and the cost of newly constructed projects receiv-

[2] United States General Accounting Office, *Report to the Chairman, Joint Committee on Taxation, Rental Housing: Costs and Benefits of Financing with Tax-Exempt Bonds* (GAO/RCED-86-2), February 1986.

ing other Federal subsidies placed in service in 1987 are eligible for a maximum four percent credit, also paid annually for ten years. For buildings placed in service after 1987, these credit percentages will be adjusted to maintain a present value of 70 percent and 30 percent for the two types of credits.

The credit amount is based on the qualified basis (defined below) of the housing units serving the low-income tenants. Low-income tenants for purposes of the low-income housing tax credit are defined as tenants having incomes equal to or less than either 50 percent or 60 percent of area median income, adjusted for family size. The qualifying income for a particular property depends on the minimum percentage of units that the owner elects to provide for low-income tenants. Rents that may be charged families in units on which a credit is claimed may not exceed 30 percent of the applicable income qualifying as "low", also adjusted for family size.

To qualify for the credit, residential rental property must comply continuously with all requirements of the credit throughout a 15-year compliance period. A credit allocation from the appropriate State or local credit authority must be received by the owner of property eligible for the low-income housing tax credit, unless the property is substantially financed with the proceeds of tax-exempt bonds subject to the new private activity bond volume limitation. These provisions are further explained in the following sections.

Credit amount and credit period

The Act provides two separate credit amounts: (1) a 70-percent present value credit for qualified new construction and rehabilitation expenditures (in excess of specified minimum amounts per unit) that are not federally subsidized and (2) a 30-percent present value credit for other qualifying expenditures. Expenditures qualifying for the 30-percent present value credit consist of the cost of acquisition of an existing building (including certain rehabilitation expenditures which are incurred in connection with acquisition and which do not exceed prescribed minimum amounts), and federally subsidized new construction or rehabilitation expenditures.

A taxpayer's credit amount in any taxable year is computed by applying the appropriate credit percentage to the appropriate qualified basis amount in such year, as defined below.[3] Except as described below, both credits are claimed annually over a 10-year period.

The credit period is the 10-year period beginning with the taxable year in which the building is placed in service or, at the election of the taxpayer, the succeeding taxable year. The credit may not be claimed for a taxable year in which the building is not in compliance with all requirements of the credit.

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[3] Congress understood that in certain cases low-income rental housing tax credit projects would be owned indirectly through partnerships. Congress intended that Treasury Department regulations will include rules treating partnerships as if they were taxpayers where appropriate to carry out the objectives of the tax credit. Congress intended, for example, that the partnership be treated as the taxpayer for purposes of determining whether a building is new (sec. 42(i)(4)). Where a partner's interest changes during a taxable year, it is intended that each partner's distributive share of the tax credit be determined under general partnership allocation rules (*see* sec. 706), i.e., by the use of a method prescribed in Treasury Department regulations that takes into account the varying interests of the partners in the partnership during such taxable year.