INFORMATION UPDATE:

Tax Incentives For Rehabilitating Historic Buildings.

TAX LEGISLATION AND REGULATIONS

TAX REFORM ACT of 1986 (Public Law 99-514)

On October 22, 1986, President Ronald Reagan signed the Tax Reform Act of 1986 (Public Law 99-514), a sweeping reform of the Internal Revenue Code of 1954, into law. This new legislation will affect nearly all individuals and businesses in major ways. Although it reduces personal income tax rates to two brackets of 28% and 15% and corporate tax rates to a maximum of 34%, it broadens the tax base by eliminating a number of deductions, tax credits, and other tax benefits. Finally, it redesignates the tax code as the Internal Revenue Code of 1986.

The Tax Reform Act of 1986 will have a significant impact on the real estate industry in general and historic preservation in particular. Several provisions of the bill directly affect certified rehabilitations; other provisions will have an indirect effect. Despite the loss or sharp curtailment of tax benefits for real estate, the rehabilitation tax credit has been retained under the new law.

In general, the provisions of the Tax Reform Act of 1986 are effective on January 1, 1987. Those provisions that relate to the treatment of income, deductions and credits will affect the tax benefits from rehabilitation projects already completed as well as future projects. Because of the complexity of the new tax law, individuals are stongly encouraged to consult legal counsel or the appropriate office of the Internal Revenue Service for assistance in determining the tax consequences of the provisions described in this fact sheet. These descriptions are provided for general informational purposes only.

1. <u>Investment Tax Credits (ITC)</u>: The current 25% ITC for certified rehabilitations will be reduced to 20% with a full adjustment to basis (currently half adjustment), and the 15% and 20% ITCs for rehabilitations of older commercial buildings will be combined into a single 10% ITC for buildings built before 1936. The new ITC provisions do not apply to rehabilitations completed pursuant to contracts that were binding as of March 1, 1986, or where the property was acquired and a Historic Preservation Certification Application was on file by March 1, 1986, if such rehabilitated properties are placed in service before January 1, 1994. For non-historic rehabilitations completed pursuant to contracts binding as of March 1, 1986, and not completed by December 31, 1986, a 10% or 13% ITC will be substituted for the 15% or 20% ITC, respectively.

2. <u>New ITC for Low Income Housing</u>: All existing incentives for low income housing will be replaced with a new 9% ITC per year for 10 years for each unit of low income housing constructed or rehabilitated without other Federal subsidies and a 4% ITC per year for 10 years for units constructed or rehabilitated with other Federal subsidies or tax-exempt bonds. This new ITC is effective for buildings placed in service after December 31, 1986, and before January 1, 1990.

3. <u>Depreciation</u>: Property placed in service as of January 1, 1987, will be depreciated using the straightline method over 27.5 years for residential real estate and over 31.5 years for commercial real estate. In general, the new depreciation provisions do not apply to property that was subject to a binding contract for acquisition or construction as of March 1, 1986, or was under construction as of March 1, 1986, if such property is placed in service by January 1, 1991.

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4. <u>Passive Losses and Credits:</u> Effective January 1, 1987, income and losses will divided into three categories: "active" (salaries, business income), "portfolio" (interest, dividends), and "passive" (income from sources in which the taxpayer does not materially participate). Rental real estate, other than that involving services such as hotels, is considered a passive activity, irrespective of material participation. Material participation is defined as involvement in the activity on a regular, continuous, and substantial basis; limited partners are categorized as not materially participating. Generally, taxpayers will be barred from using losses and credits from passive sources to avoid taxes on active or portfolio income; losses and credits from passive sources will be allowed only against other passive income. This key change will dramatically affect how future rehabilitation projects are financed (by virtual elimination of currently-structured syndications) and will affect tax benefits derived from already completed projects owned by limited partnerships.

   The passive losses/credits rule will be phased in over four years and will permit investors in projects completed prior to January 1, 1987, to take 65% of their existing tax benefits (losses and credits) in 1987; 40% in 1988; 20% in 1989; and 10% in 1990, with full elimination of passive losses/credits in 1991. Unused passive losses and credits can be carried forward indefinitely and can be applied against gains upon disposition of the property.

   Under the special rules described below, an annual <u>total</u> of $25,000 in passive losses and credits from real estate activities may be computed by certain taxpayers against active income. For example, if a taxpayer incurs $10,000 in losses from rental real estate, the remaining amount for computation of available tax credits is $15,000.

   <u>"Passive Loss" Rules for Rental Real Estate:</u> Certain taxpayers who "actively participate" in their rental real estate activities (both historic and non-historic) may be able to take up to a total amount of $25,000 in passive losses annually or claim an equivalent amount of credits. "Active participation" will be specifically defined by the Internal Revenue Service in regulation; appears to be less restrictive than "material participation;" and excludes limited partnerships. Individuals with joint taxable incomes less than $100,000 ($50,000 for single taxpayers) may take up to $25,000 in losses annually from rental real estate. This $25,000 annual limit on losses would be reduced for individuals with taxable incomes between $100,000 and $150,000 and eliminated for individuals with taxable incomes over $150,000. Qualifying individuals with taxable incomes of $250,000 or less may take up to $25,000 in losses from certified rehabilitation or low-income housing projects.

   <u>"Passive Credit" Exemption:</u> Tax credits from passive sources, including rental real estate, can be used to offset the <u>tax</u> owed on up to $25,000 of "active income" for taxpayers with incomes less than $100,000. This passive credit exemption is reduced for individuals with incomes between $100,000 and $150,000 and eliminated for individuals with incomes over $150,000. For taxpayers in the 28% bracket, the maximum allowable credit would be 28% of $25,000 or $7,000. <u>The exemption is not a $25,000 credit but a credit on the tax on $25,000 of "active income."</u>

   <u>"Passive Credit" Rules for Rehabilitations and Low-Income Housing:</u> The $25,000 allowance for credits <u>(but not losses)</u> from rehabilitations and low-income housing applies to individuals, <u>including limited partners</u>, having incomes up to $250,000.

5. <u>Capital Gains:</u> Effective January 1, 1987, the exclusion of 60% of a long-term capital gain is repealed and capital gains will be treated as ordinary income taxable at the top rate of 28%.

6. <u>Tax-Exempt Bonds:</u> Effective January 1, 1987, States and local jurisdictions would be limited in the total dollar amount of bonds issued for quasi-governmental purposes, such as industrial development bonds, to the greater of $250 million or $75 per capita per state.