Tax Considerations for Rural Housing Preservation

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Summary

A crisis is building for many federally supported rental properties, which are an important source of affordable housing for low-income rural residents. Particularly, USDA Section 515 mortgages are nearing the ends of their terms, and property owners may wish to convert their properties to other uses (for example, market-rate housing) or sell them to others who will convert them. If owners sell to entities that will continue to use them as affordable rentals, rural tenants benefit and the existing federal investment in these properties is protected. Yet many owners are reluctant to sell their properties for preservation because they will experience adverse tax consequences at sale. This paper explores those tax consequences, indicates where they may have the greatest impact, and suggests ways they might be mitigated in order to encourage preservation.

Tax consequences arise as a result of depreciation over the lifetime of a rental property. Federal tax law allows a rental property owner to reduce their annual tax liability by claiming depreciation in the property's value every year. When the property is sold, however, tax law requires that a portion of the taxes deferred by depreciation must be recaptured. If a property's market value has appreciated over time, a higher sales price can cover the depreciation recapture and also provide the seller with a profit. If the value has not appreciated, however – as is the case in many rural areas – or when a purchaser needs to buy at less than market value in order to preserve affordability, the tax liability can use up most or all of the sales receipts.

The paper presents several technical, market and legislative strategies that could help mitigate the identified tax-related barriers and enhance preservation efforts.

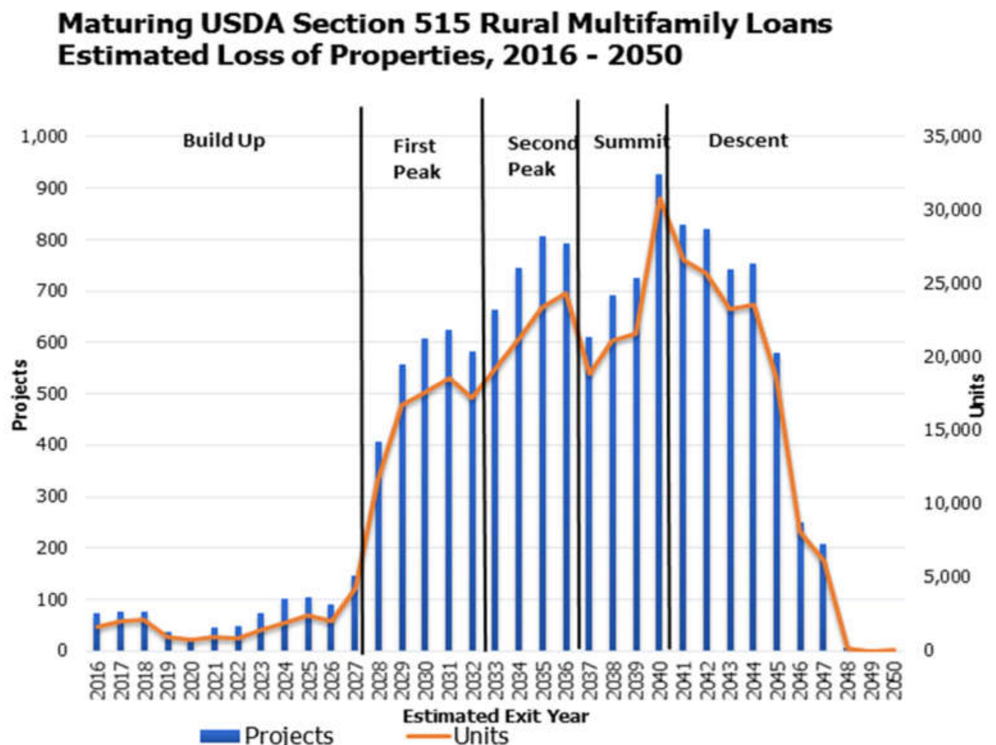
INTRODUCTION

A crisis is building for rental properties financed through the Section 515 program of the U.S. Department of Agriculture (USDA), which are an important source of affordable housing for low-income rural residents. Section 515 mortgages are nearing the ends of their terms, and property owners may wish to convert their properties to other uses (for example, market-rate housing) or sell them to others who will convert them. If owners sell to entities that will continue to use them as affordable rentals, rural tenants benefit and the existing federal investment in these properties is protected. Yet many owners are reluctant to sell their properties for preservation because they will experience adverse tax consequences at sale. This paper explores those tax consequences, indicates where they may have the greatest impact, and suggests ways they might be mitigated in order to encourage preservation.

Preservation Issues Related to Tax Relief

Section 515 Rural Rental Housing properties began operation in 1963 and production peaked in 1979 with 1,645 loans to construct 38,650 units of affordable rental housing. Funding levels fell sharply in the mid-1980s, then again in the mid-1990s. The program last funded new development in 2011; since 2012, it has been used to help preserve aging Section 515 properties. As of September 2018, USDA's portfolio of outstanding Section 515 loans covered 400,372 units.[1]

The Housing Assistance Council (HAC) published a report in September 2018 illustrating the need for preservation of USDA's Section 515 portfolio.[2] Program mortgages are beginning to reach the ends of their terms. HAC calculated that an average of 74 properties (1,788 units) will leave the program each year through 2027. Then three phases of four or five years each will see 2,800-3,000 properties (82,000-92,500 units) maturing. Without additional preservation activities, by 2050 all Section 515 mortgages will have ended. When the USDA mortgage ends, the property also loses its Section 521 Rental Assistance and, even if a property continues to offer rental units, tenants unable to pay higher rents lose their homes.



In 2019 Section 515 tenants averaged $13,551 annual income, and those receiving Rental Assistance had an average income of only $11,285.

The majority (65 percent) of Section 515 residents are elderly or disabled.[3] In many rural places or small towns, Section 515 properties have offered the only decent, affordable rental housing for these tenants. Thus, the loss of these units could mean the end of affordable housing for hundreds of thousands of rural Americans.

Preservation Purchasers

While the owner of a Section 515 property can preserve it by refinancing and continue to operate it as affordable housing, in many cases the owner seeks to sell the property or is willing to sell it. A typical rural preservation transaction involves a "mom and pop" or a limited partnership owner of an aging property with some deferred maintenance needs selling to a "preservation purchaser," a nonprofit organization or a mission-focused for-profit that needs to find financing to cover not only the purchase but also renovations and updates to the property. Project reserve funds are usually inadequate to cover the deferred maintenance, let alone any upgrades.

Some owners hope to earn a profit on such a sale, often an unrealistic goal if the property is to be preserved as affordable housing. Many owners are willing to forgo profit, but they do need to cover their costs. Probably the most significant cost is the tax liability incurred at sale. All too often, the tax consequences of selling an affordable rental property give the seller an incentive to maximize the sales price, even if that means the property will be lost as affordable housing. Rural rental housing preservation can be increased, then, if these tax consequences can be mitigated.

Methodology

To examine owners' tax consequences at preservation sales and develop recommendations to address them, HAC reviewed a variety of written sources and conducted interviews with subject matter experts. Relevant documents included Internal Revenue Service publications on rental property ownership and disposition of assets; articles that advise property owners on tax law; bills introduced in Congress to address owners' concerns; and testimony before congressional committees. Experts consulted for this study included two attorneys who structure preservation transactions, two former USDA officials with preservation expertise and a representative of rural rental property owners.

This analysis also drew on recent research on rural multifamily preservation as well as various data sources including publicly available USDA program data and resources located on the Multi-Family Housing subsection of the Rural Development Datasets website, the U.S. Census Bureau's 2010 Census of Population and Housing, the American Community Survey Five Year Estimates, the USDA Economic Research Service's county typology and other datasets.[4]

TAX BENEFITS AND CONSEQUENCES

Tax liabilities to the seller of a Section 515 property can arise from capital gains, depreciation, debt forgiveness or grants provided to the seller as part of the sale. The seller has received benefits, including tax deductions, throughout the years they have owned the property. They may have received income from rents or from serving as property manager. If an individual owner's income was high enough for them to itemize deductions, they could take tax deductions for mortgage interest payments, property taxes, and other expenses of operating the property. The tax savings may not have been equal to the tax due at sale, however. Even if they were, the tax "hit" may be unexpected.

Depreciation, Recapture and Capital Gains[5]

Real property structures (not the land on which they stand) that are rented out for income can be depreciated over 27.5 years. Depreciation reduces the owner's tax liability each year and also reduces the owner's basis in the property. After 27.5 years of ownership, then, the owner's basis is zero. When the owner sells the property, they are liable for a depreciation recapture tax of 25 percent on the sales proceeds up to the amount of depreciation taken and a capital gains tax on any sales proceeds that exceed the depreciation taken.

For example, if an individual developed or purchased a Section 515 property in 1990 for a total cost of $4 million – $1 million for the land and $3 million for the building – and depreciated the property over 27.5 years, by 2018 their basis in the land would be $1 million and their basis in the building would be zero. If they sell the property for $6 million in 2019, they owe 25 percent depreciation recapture tax on $3 million and capital gains tax on $2 million.

The capital gains tax rate is lower than the 25 percent depreciation recapture tax rate and is lower than the rate for ordinary income; it is 0 percent, 15 percent or 20 percent, depending on the seller's income and filing status.[6]

Debt Forgiveness and Grants

Debt forgiveness is another way a tax liability can arise. If the preservation sale of a Section 515 property involves forgiving part of the seller's outstanding debt on the property, the amount of debt forgiven is considered taxable income to the seller. Similarly, if an entity wished to support preservation by paying the seller's tax liability, that grant would be considered taxable income to the seller.

Existing Strategies for Tax Relief

Those who have expertise in structuring rural housing preservation sales have learned to take tax liability into account in establishing sales prices. That may not be enough, however, for some sellers – "mom and pop" owners who did not anticipate the tax consequences and do not have funds available to cover them if the sales price falls short, for example, or for-profit owners or partnerships who wish to maximize profits.

There are a limited number of ways to delay, reduce or eliminate depreciation recapture tax. Capital gains tax can be reduced by offsetting capital losses, but there is no equivalent for depreciation recapture tax. A new option for capital gains tax was created in the 2017 tax reform act,[7] but it does not apply to depreciation recapture tax. If the seller reinvests the sales proceeds in a Qualified Opportunity Fund or

Funds, she can delay – and eventually eliminate – the capital gains tax.[8] This option is more generally known as the Opportunity Zones program; Qualified Opportunity Funds are used for community development in Opportunity Zones.[9]

Both the depreciation recapture tax and the capital gains tax can be delayed if the seller uses a "1031 like-kind exchange" to reinvest her sale proceeds in a similar property or properties within a short time period.[10] Both taxes can be eliminated by selling the property at a loss. And both can be eliminated or greatly reduced if the property owner is a human being (not a corporation or partnership) who dies, because the owner's heirs do not inherit the owner's basis in the property. Their basis is the property's value at the time of inheritance. The stepped-up basis gives some individual Section 515 owners a reason to keep the property until they die, so that their heirs can sell it without incurring depreciation recapture or capital gains tax.

Data Analysis: Where the Impact May be Greatest

The tax implications of sale may have a greater impact in some situations than others. The available data does not permit a deep analysis of the possibilities, but research HAC conducted in 2017 and 2018 sheds some light.

Seller Characteristics

Nonprofit sellers are least likely to be impacted by the presence or absence of tax relief, since they are exempt from paying taxes. Individuals or small corporations ("mom and pop" owners) may be the most likely to be affected, and people with rural preservation experience report those owners are the least likely to have anticipated the tax consequences of sale. Tax credit partners reportedly have greater knowledge of the balance between the benefits of affordable housing ownership and the disadvantages of tax liabilities at sale.

HAC's research was able to compare some characteristics of nonprofit owners and for-profit owners, but the data did not allow examination of different types of for-profit owners (individuals, corporations or partnerships).[11] The available figures showed that historically Section 515 properties with nonprofit owners are slightly less likely to leave the program than are those with for-profit owners. They also revealed that nonprofits own a far higher proportion of Section 515 properties built in the program's early years than of those constructed after 1974. That dichotomy may occur because over time nonprofits have purchased those properties from their original owners, but information on changes in ownership is not available.

These findings do not point to any particular tax policy changes that might improve preservation. While nonprofit owners are less likely to leave the Section 515 program, some nonprofits do leave; since tax relief does not impact nonprofits, tax relief would not help preserve those properties.

There is no information available about owners' reasons for leaving the program, the market for those properties or their affordability after they leave USDA's portfolio. Some leave the program because they are no longer needed as affordable housing. And some continue to serve as affordable housing without the Section 515 and 521 subsidies and the accompanying use restrictions. Without further information about the reasons other owners chose to leave or remain in the program, it is impossible to determine how often

tax relief would encourage them to transfer their properties to preservation purchasers.

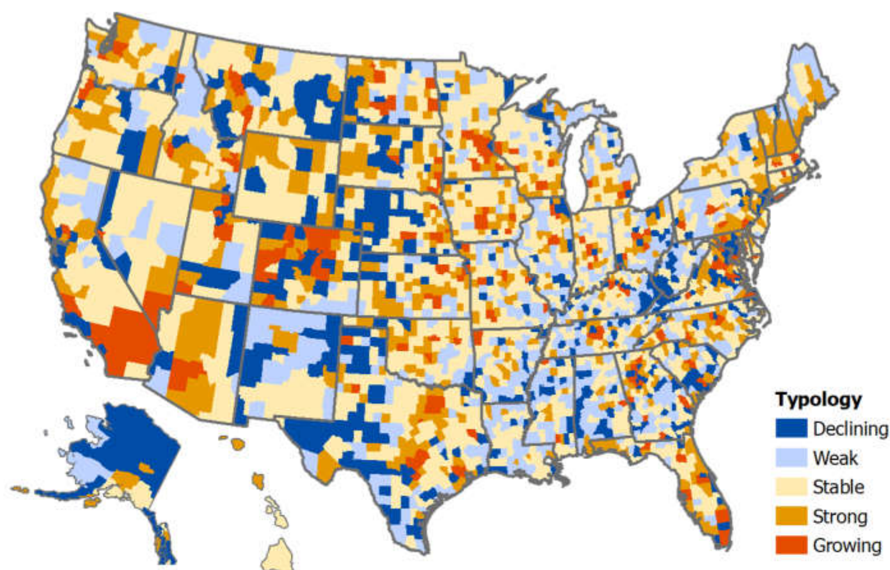
High or Low Sale Prices

Sale prices could affect owners' willingness to sell their Section 515 properties in either strong markets or weak markets. In a strong market with relatively high sales prices, a preservation purchaser may not be able to match the price the property could command from a seller interested in converting it to a higher-yield use. This could be true regardless of the existence of tax relief, of course. But a higher sales price means a larger gap between the seller's basis and his gain, resulting in higher capital gains tax upon sale. A preservation purchaser must find enough financing to offer the market price, including enough to cover the tax liability.

In a weak market with low sales prices, it may be even more difficult for a preservation purchaser to offer a price high enough to cover the seller's tax liability. The purchaser is unlikely to be able to offer an above-market price – even where an above-market price is lower than the market price in another area – because the purchaser must be able to break even in operating the property after the sale and any renovations, and therefore cannot take on excess debt in a place where rents are likely to be low. Thus tax relief might be important to encourage preservation sales in these areas also.

HAC's rural rental preservation research recognized declining and growing markets as having the highest risk of losing Section 515 properties. HAC developed an index that identified 135 counties containing Section 515 properties as having the weakest rental markets and 200 counties as having the strongest. Over 1,600 properties with 48,000 units are located in these 335 counties, representing about 12 percent of properties in the Section 515 portfolio.[12]

Rental Market Typology



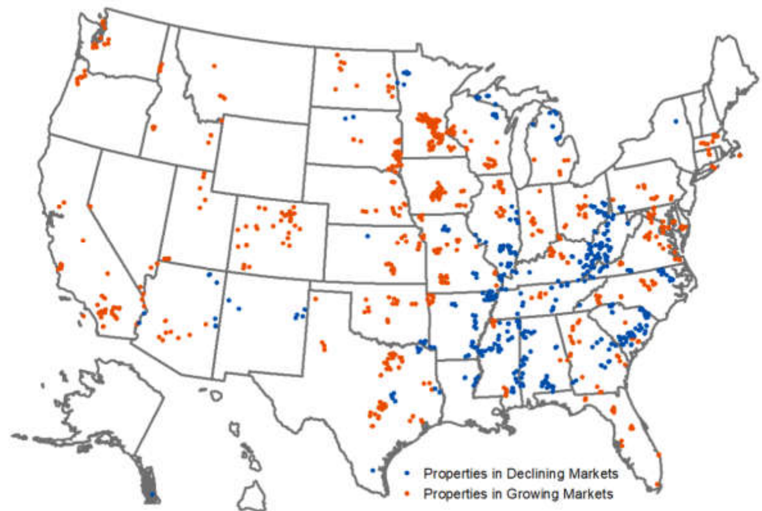
Source: Housing Assistance Council (HAC) Tabulations of USDA and Census Bureau Data

As the map shows, the hottest markets are generally concentrated around metropolitan areas throughout the country. The majority of high-risk properties (61 percent of high-risk properties and 64 percent of high-risk units) are in growing markets, where sales prices – and the corresponding tax liabilities – are likely to be high.

The weakest markets are concentrated in Appalachia and the Southeastern U.S., although there are also some strong markets in those parts of the country. Reflecting the Southeast's

population, about 45 percent of tenants in the weaker markets are African American.

Section 515 Properties in Growing and Declining Markets



Source: Housing Assistance Council (HAC) Tabulations of USDA and American Community Survey Data

Section 515 units in the weak market properties are also more likely to have USDA Section 521 Rental Assistance (RA), at 67 percent compared to 56 percent in the strongest markets. The difference probably reflects lower incomes due to more constrained economic opportunities in the weakest markets. Because Section 521 RA can be used only in properties with USDA Section 514 or 515 mortgages, this higher reliance on RA also means the tenants in those units are more likely to need some other kind of assistance if their homes leave the Section 515 portfolio.

If only limited tax relief was available, or if a tax relief demonstration program was instituted to test the scheme's efficacy, the relief could be targeted to these most-at-risk properties in declining and growing markets.

POSSIBLE STRATEGIES FOR TAX RELIEF

Tax relief to sellers of affordable rural rental housing could be provided by changing tax law to reduce or eliminate the tax liability, or by reimbursing sellers for their tax liability.

Tax Law Changes

Tax law could be changed in a variety of ways to eliminate or reduce the tax burden on sellers of Section 515 properties. Perhaps the most direct approach was proposed in legislation that was introduced in the 2000s but never considered by either the House or the Senate. It would have excluded from a seller's income the gain attributable to depreciation when affordable rental property was sold to an entity that agreed to preserve it as affordable housing for 30 years.[13] The Council on Affordable and Rural Housing, the trade association for Section 515 owners, continues to support this approach, recommending it in testimony before a House of Representatives subcommittee in April 2019.[14]

Another alternative, proposed in legislation that was introduced in 2003 but not considered, would have created a tax credit for the seller.[15] Like the exclusion from income proposals, the credit would have applied to the entire tax liability at sale. It would have equaled the tax attributable to gain, divided by any cash or the value of any property received in connection with the sale. Thus, it would not have eliminated a seller's tax liability, but would have reduced it somewhat.

As noted above, the new Opportunity Zone program allows deferral and eventual cancellation of capital gains tax. It applies to any capital gains, not exclusively to capital gains attributable to the sale of affordable rental property. The program could be amended to apply to depreciation recapture tax as well.

Most changes in the tax code are subject to disagreement among stakeholders, and these tactics would be no exception. Any of these approaches would reduce the taxes collected by the federal government. Some stakeholders are likely to support that result and others are likely to oppose it. Differences of opinion are also likely regarding the desirability of preserving past government investment in assisted housing and regarding the continued provision of assisted housing.

Reimburse Sellers

At least one tax relief option does not involve amending the tax code. An entity interested in supporting rural rental housing preservation could pay a seller's tax liability. The amount of the payment would be considered income to the seller. Using the example above, a seller who owes 25 percent depreciation recapture tax on $3 million and 20 percent capital gains tax on $2 million would have a tax liability of $1.15 million. If another entity paid that $1.15 million, the seller's tax liability connected to the sale would be reduced to, at most, 37 percent (the highest individual tax rate in 2019; corporate tax rates are lower[16]) of $1.15 million, or $462,500.

This approach might be politically more palatable than changing the tax code, and it would not reduce the federal government's income. Even if some entity or entities were willing to spend millions of dollars on rural rental preservation, however, this might not be the most cost-effective way of using those dollars. Investing the funds in Low Income Housing Tax Credits for recapitalization of preservation properties, or

even for new construction, might impact more rental units. The money could also be used for technical assistance to increase the capabilities of preservation purchasers, or to collect data to better inform policy choices, to preserve units that are greatly needed in their individual markets (whether weak or strong) or in many other ways.

CONCLUSION

Tax relief for sellers of Section 515 properties could be an important new tool in efforts to preserve affordable rural rental housing. It would also increase the cost of preserving this housing stock. The most effective possibilities for relief require action by Congress and the President to change the tax code. Such a change may be politically difficult, particularly because major tax legislation was enacted in 2018. Yet more of the nation's dwindling supply of assisted housing units will be lost if tax relief is not addressed.

NOTES

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[1] Results of the 2019 Multi-Family Housing Annual Fair Housing Occupancy Report, Unnumbered Letter from Bruce W. Lammers, Administrator, Rural Housing Service, U.S. Department of Agriculture, December 5, 2019, https://www.rd.usda.gov/sites/default/files/RDUL-MFHannual1.pdf.
[2] Rental Housing for a 21st Century Rural America: A Platform for Preservation (Washington, DC, Housing Assistance Council, 2018), http://www.ruralhome.org/sct-information/mn-hac-research/mn-rrr/1602-rpt-platform-for-preservation.
[3] Results of the 2019 Multi-Family Housing Annual Fair Housing Occupancy Report.
[4] More details about that analysis are provided in Platform for Preservation, Appendix A.
[5] This is a simplified explanation. Basis is affected by other things such as improvements to the property, and components such as carpeting are depreciated over fewer years because they are considered to have shorter lifespans. Tax consequences can be impacted by other factors as well, such as the terms of the partnership agreement when the property owner is a partnership.
[6] Matthew Frankel, Long-Term Capital Gains Tax Rates in 2020, The Motley Fool, December 7, 2019, https://www.fool.com/investing/2019/12/07/long-term-capital-gains-tax-rates-in-2020.aspx.
[7] Tax Cuts and Jobs Act of 2017, P.L. 115-97, Section 13823, https://www.congress.gov/115/plaws/publ97/PLAW-115publ97.pdf.
[8] Internal Revenue Service, 2018 Instructions for Schedule D, Capital Gains and Losses, January 2020, https://www.irs.gov/pub/irs-pdf/i1040sd.pdf.
[9] Internal Revenue Service, Opportunity Zones Frequently Asked Questions, October 22, 2019, https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions.
[10] CWS Capital Partners LLC, What Is a 1031 Exchange? The Basics for Real Estate Investors, n.d., https://www.cwscapital.com/what-is-a-1031-exchange/.
[11] Platform for Preservation, p. 81.
[12] Platform for Preservation, pp. 58-60.
[13] The Affordable Housing Preservation Tax Relief Act of 2005, H.R. 3715, introduced September 8, 2005,
2009, https://www.congress.gov/bill/109th-congress/house-bill/3715; the Affordable Housing Preservation Act of 2006, S. 3616, introduced June 29, 2006, https://www.congress.gov/bill/109th-congress/senate-bill/3616; the Affordable Housing Preservation Tax Relief Act of 2007, H.R. 1491, introduced March 13, 2007, https://www.congress.gov/bill/110th-congress/house-bill/1491; the Affordable Housing Preservation Act of 2007, introduced May 7, 2007, https://www.congress.gov/bill/110th-congress/senate-bill/1318; the Affordable Housing Preservation Tax Relief Act of 2009, H.R. 2887, introduced June 16, 2009, https://www.congress.gov/bill/111th-congress/house-bill/2887.
[14] Testimony of Tanya Eastwood on Behalf of the Council for Affordable and Rural Housing Before the Subcommittee on Housing, Community Development and Insurance, House Financial Services Committee, The Affordable Housing Crisis in Rural America: Assessing the Federal Response, April 2, 2019, https://financialservices.house.gov/uploadedfiles/hhrg-116-ba04-wstate-eastwoodt-20190402.pdf.
[15] The Affordable Housing Preservation Tax Relief Act of 2003, H.R. 3485, introduced November 12, 2003, https://www.congress.gov/bill/108th-congress/house-bill/3485.
[16] Internal Revenue Service, Tax Reform Basics for Individuals and Families, Internal Revenue Service Publication 5307, https://www.irs.gov/pub/irs-pdf/p5307.pdf, p. 1.

This white paper was prepared by the Housing Assistance Council (HAC). HAC is a national nonprofit corporation that helps build homes and communities across rural America. Since 1971, HAC has provided financial products, technical assistance and training, and research and data services that enable rural communities and rural people to thrive and prosper.

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