Renewal Community Federal Income Tax Incentives

QUESTIONS & ANSWERS

The following questions and answers are based on guidance provided by the U.S. Department of Housing and Urban Development. This information is not definitive nor is it intended to cover all Renewal Community tax provisions. Businesses are advised to always consult with their tax advisors regarding the application of these provisions.

A. RENEWAL COMMUNITY EMPLOYMENT CREDIT (RC WAGE CREDIT)

Question A.1: The RC Wage Credit can be claimed on qualified wages. What is the definition of "qualified wages"?
Answer: Qualified wages are generally wages subject to the Federal Unemployment Tax Act (FUTA). The credit is calculated against a maximum of $10,000 in wages earned by employees who reside in the RC and who work for an RC business. A business may pay the employee more than $10,000, but the maximum amount against which the credit can be claimed is $10,000. The instructions for IRS Form 8844 (the form that accounts for the credit) provide additional information on qualified wages.
Example: *A business located in the RC has five full-time employees and one part-time employee. The full-time employees all earn over $25,000 per year and the part-time employee earns $8,000 per year. Three of the full-time employees and the part-time employee all reside in the RC. The taxpayer may claim employee tax credits totaling $5,700 against his or her federal income taxes (15 percent of the maximum $10,000 for each of the three RC resident employees plus 15 percent of the $8,000 in wages for the part-time employee).*

Question A.2: How does a business document that an employee is an RC resident?
Answer: The employer should obtain a statement from the employee that gives the address of the employee's principal residence and provides assurance that the employee will notify the employer of a change in the employee's principal residence. The local RC administrator can confirm that the address is in the RC. These statements need not be filed with the business's tax return, but should be retained like any other documents supporting a tax return. Employers who hire through the City's Enterprise Zone Job Referral Service will receive a voucher for each employee hired, and if the employee is an RC resident, there will be a box checked. This can serve as the initial verification of RC residence, but the employer is responsible for tracking any residency changes.

Question A.3: What if the employee works part-time?
Answer: The credit is available for both part-time and full-time employees as long as the employer has employed them for at least 90 days. The amount of the credit is tied to the amount of wages paid rather than to the number of hours worked.

Question A.4: What if the employee works in an RC for only part of the year?

Answer: An employer can use either the pay-period or calendar year method for determining the period of time the employee performs services in an RC. No other time periods can be used to prorate the credit.
Example: *If an employee works in several factory locations and is paid weekly, an employer can claim the wage credit for the weekly pay periods during which the employee works substantially all of his or her time in the factory located in the RC. "Substantially all" is defined as 85 percent for the purposes of some of the tax incentives, but the regulations on the RC Wage Credits do not define "substantially all." The employer must use the same method for all employees, but may change the method applied to all employees from one taxable year to another.*

Question A.5: Is there a limit on the number of employees for which a business can take the credit?
Answer: No. An employer can take the credit for as many employees as qualify.

Question A.6: Which categories of employees would not qualify for the RC Wage Credit?
Answer: The RC Wage Credit cannot be taken for any individual employed at any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other gambling facility, or store whose principal business is the sale of alcoholic beverages for consumption off premises. The credit is not available for family members of the employer, including sons, daughters, parents, stepchildren, stepmother, stepfather, in-laws, and other persons treated as dependents under the tax code. Similar exclusions apply to 5-percent owners related to the employer and family members of majority shareholders or partners of the employer.

Question A.7: Can the owner of an RC business claim the Wage Credit on the wages of the owner's sister who works for the business, lives in the RC, and is married and files her taxes separately from the employer?
Answer: No.

Question A.8: Can the owner of an RC business claim the Wage Credit on the wages paid to a homeless individual?
Answer: While the Wage Credits can be claimed only on the wages of persons whose "principal place of abode" is in the RC, there is no published IRS guidance on this issue. The employer is responsible for proving that the employee's principal place of abode was within the RC during the period the services were performed for the employer, and presumably this is the address the employee would have entered on Form W-4 upon starting work. There seems to be no reason why a homeless shelter could not be considered a principal place of abode. This is a compliance matter and would be raised, if at all, only during an audit of the employer's tax return.

Question A.9: Which types of organizations do not qualify to claim the RC Wage Credit?
Answer: The RC Wage Credit is not relevant to:
- Businesses that are located outside an RC
- Businesses that have no tax liabilities
- Nonprofit organizations (other than farmers' cooperatives)

- Businesses whose employees spend the majority of their time (by pay period or calendar-year) working outside an RC

<u>Question A.10</u>: Can an employer count the time an employee is on a tour boat in San Diego Bay that starts and stops its tours in the Renewal Community for the purpose of claiming the RC Wage Credit?
<u>Answer</u>: To qualify for the credit, substantially all of the services performed by the employee for the employer must be performed within the Renewal Community. Any services that are performed outside of the Renewal Community's geographic boundaries would not count under this test. Thus, if most of the tour boat's time is not in the RC geographic boundaries, then the employee's time may not be "substantially all." Likewise, a delivery service that is headquartered in the RC may not meet the test if much of its employees' time is spent on delivery runs outside the RC.

<u>Question A.11</u>: What does "substantially all" mean with regard to an employee's services performed, and how does a business determine if an employee meets this test?
<u>Answer</u>: The IRS has not published guidance on this question that specifically relates to the RC Wage Credit. However, the IRS recently ruled that "substantially all" means "80 percent or more" as it relates to identical statutory language regarding services performed by New York Liberty Zone business employees for purposes of the Work Opportunity Tax Credit. So, in the absence of any other guidance, it is not unreasonable to apply that same percentage for purposes of the RC Wage Credit.

<u>Question A.12</u>: Can entities that lease their employees use the credit?
<u>Answer</u>: Employers should check with their tax advisors. The RC Wage Credits are based on FUTA wages, so the ability to take the credit will depend on who the employer is for purposes of the FUTA wages.

<u>Question A.13</u>: With respect to RC Wage Credit, is the 90-day period calculated based on the calendar, or on days worked?
<u>Answer</u>: The 90-day test is based on calendar days, not days worked.

<u>Question A.14</u>: Are tips considered Qualified Wages in order to determine the RC Wage Credit?
<u>Answer</u>: No. Wages are defined in IRC section 1397 by reference to IRC section 51, which in turn defines them by reference to IRC section 3306(b). Because tips are counted as wages under IRC section 3306(s), not IRC section 3306(b), tips do not count as wages for figuring the Renewal Community employment credit.

<u>Question A.15</u>: What if the federal tax liability of the business is less than the total RC Wage Credit amount?
<u>Answer</u>: The RC Wage Credit generally is subject to the same rules as other business tax credits. As with other business tax credits, unused credit amounts can be carried forward for up to 20 years and carried back a year. However, the credit cannot be carried back prior to the RC designation.

<u>Question A.16</u>: Can a pass-through entity, such as a partnership or S-corporation, use the Credit?
<u>Answer</u>: The RC Wage Credit is a general business tax credit for federal tax purposes and may be passed through under the rules similar to other business tax credits.

<u>Question A.17</u>: Can a business that obtains RC Wage Credits transfer or sell those credits to another business entity?
<u>Answer</u>: No. There is no provision in the Internal Revenue Code that allows one entity to transfer an unused Renewal Community employment credit to another entity.

<u>Question A.18</u>: How does the RC Wage Credit affect the deduction for salaries and wages?
<u>Answer</u>: A business must reduce the deduction for salaries and wages by the amount of the credit taken.

<u>Question A.19</u>: Can a building construction site in a Renewal Community qualify for Renewal Community employment credits?
<u>Answer</u>: The RC employment credit is available for any RC business if the business's employee performs substantially all of its services during the period in the RC and also lives in the RC. The IRS has interpreted the language "the period" to include pay periods. So, if an employee is working at a construction site for substantially all of specified pay periods, the wages paid during those pay periods would be qualified wages eligible for the 15 percent credit up to $10,000 per year in wages. The employee must live the in the RC that same time period.

<u>Question A.20</u>: Are there special procedures for taking the RC Wage Credit?
<u>Answer</u>: The credit is accounted for on IRS Form 8844 and would be part of a business's tax filing.

<u>Question A.21</u>: If the tax year for a business were other than the calendar year, when would the business claim the RC Wage Credits? For example, if the business's fiscal year runs from October 1, 2001, through September 30, 2002, should it claim all credits earned during this period when it files its 2002 tax return or should it claim the October through December, 2001, credits in its 2001 tax return and then claim the January through September, 2002, credits in its 2002 tax return?
<u>Answer</u>: The credit is based on the qualified wages paid or incurred during the CALENDAR YEAR that ENDS DURING the taxpayer's FISCAL YEAR.
<u>Example</u>: *For a taxpayer with a fiscal year ending on September 30, the credit for CALENDAR YEAR 2002 wages is claimed on Form 8844 for the FISCAL YEAR that begins October 1, 2002, and ends on September 30, 2003. That's because December 31, 2002, falls within the fiscal year ending September 30, 2003. Therefore, for the wages paid or incurred from January 1 through December 31, 2001, the credit would be claimed on the return for the fiscal year that begins on October 1, 2001, and ends on September 30, 2002. For the wages paid or incurred from January 1 through December 31, 2002, the credit would be claimed on the return for the fiscal year that begins on October 1, 2002, and ends on September 30, 2003. Therefore, even though the taxpayer's DEDUCTION is for fiscal year wages, the CREDIT is for calendar year wages.*

B. INCREASED SECTION 179 EXPENSING

Question B.1: What is the benefit of the RC's increased "expensing"?
Answer: Expensing permits a business to take a deduction for (or "write off") the full cost of equipment in the year it is purchased. In addition, this write-off of costs means that a business does not have to set up a tax depreciation schedule for an asset and deduct the expense over time. Expensing is particularly helpful for equipment with a long recovery period. If the business is located in an RC, at least 35 percent of its employees are RC residents, and the business meets other qualifying criteria, then the business may write off $35,000, in addition to the normal expensing amount, of business-related equipment purchases in the year they are purchased.
Example: *In October, 2002, an RC business spends $40,000 to purchase a widget that is used for business purposes and normally would be depreciated over seven years. The business may deduct the entire $40,000 from its gross income for the purpose of calculating its 2002 federal income tax. Otherwise, the business may deduct only $24,000 of the widget's cost in 2002 and deduct the remaining value according to the depreciation schedule.*

Question B.2: What type of property qualifies for the RC's Increased Section 179 Expensing?
Answer: The additional expensing allowance is available only for a Qualified Renewal Property (QRP), defined as the following:

- Eighty-five percent of the use of the property must be in the active conduct of a Renewal Community business by a taxpayer in an RC.
- The taxpayer acquired the property by purchase after the date of RC designation.
- Original use of the property in an RC commences with the taxpayer (that is, the taxpayer is the first person to use the property inside an RC), or the taxpayer meets the substantial renovation
  rule. Property is substantially renovated if, during any 24-month period beginning after RC designation, there are additions to the basis of the property equal to either 100 percent of the adjusted basis of the property or $5,000, whichever is greater.

Question B.3: To what types of business activities does the Increased Section 179 Expensing NOT apply?
Answer: Certain business activities do not qualify, such as:

- Residential rental activity;
- Commercial real estate (unless at least 50 percent of the gross rental income is from Renewal Community businesses);
- Rental of personal property, such as car rental agencies (unless at least 50 percent of the rentals are to Renewal Community businesses or to RC residents);
- Businesses that predominantly hold or develop intangibles for sale or license; or
- Country clubs, liquor stores, golf courses, racetracks, or gambling facilities.

Question B.4: How do the expensing phase-out limits work?
Answer: The general tax rule is that, for each $1 of Section 179 property greater than $200,000 placed in service in a tax year, the expensing allowance is reduced by $1. However, for each $1 of QRP greater than $200,000 in a tax year, the expensed amount is reduced by 50 cents.

<u>Question B. 5</u>: How does a business file for this incentive?
<u>Answer</u>: The additional expensing amount is recorded on IRS Form 4562. This form has a special line, along with instructions, for QRP. A business should consult with its tax advisor.

C. ZERO PERCENT CAPITAL GAINS RATE

<u>Question C.1</u>: What assets are eligible for zero percent capital gains in RCs?
<u>Answer</u>: The zero percent capital gains rate applies to gain for an RC asset acquired after January 1, 2002, and before December 31, 2009. Qualifying assets include: 1.) stock in a domestic company acquired by the taxpayer at its original issue from the corporation solely in exchange for cash, 2.) any capital or profits interest in a domestic partnership if the interest was acquired by the taxpayer from the partnership solely in exchange for cash, and 3.) tangible business property acquired by the taxpayer by purchase, in which either the original use of the property in an RC commences with the taxpayer or the taxpayer substantially improves the property. In the case of stock or partnership interests and ownership of the tangible business property, the business must be a Renewal Community Business when the stock, interest, or property is acquired (or be formed with the purpose of being a Renewal Community business) AND must remain a Renewal Community business for substantially all of the holding period. In every case, at least 35 percent of the RC business's employees must be RC residents.
<u>Example</u>: *On July 1, 2002, you purchase $100,000 in stock in RCBiz, Inc., a privately held corporation that meets the requirements of being a Renewal Community business, including that 35 percent of its employees are residents of the RC. On July 1, 2007, you sell the stock for $200,000. You can exclude the $100,000 gain from your gross income for the purpose of calculating your 2007 federal income tax.*

<u>Question C.2</u>: If the asset was purchased before an area receives an RC designation, does the zero percent capital gains rate apply?
<u>Answer</u>: No. The asset must be purchased after designation. If additional stock or partnership interests of an entity are purchased at original issuance after the RC designation, these additional interests might qualify.

<u>Question C.3</u>: How long must the asset be held?
<u>Answer</u>: The minimum holding period is five years.

<u>Question C.4</u>: What if a taxpayer purchased an RC asset, such as an existing building, from the taxpayer's parents?
<u>Answer</u>: The zero percent capital gains rate is not available for transactions between related persons. "Related persons" include sons, daughters, parents, stepchildren, stepmothers, stepfathers, in-laws, and
other persons treated as dependents under the tax code. Similar restrictions apply to sales to majority shareholders or partners of the business.

<u>Question C.5</u>: What if a business ceases to meet the definition of a Renewal Community business?
<u>Answer</u>: The business must meet the requirements for substantially all of the five-year holding period. "Substantially all" is not defined in the Code, but 85 percent of the period would likely

be regarded as meeting the test. If the business ceases to meet the test after the five-year holding period, the zero percent rate applies, but only to the extent of the gain to the date the business failed to meet the requirements.
Example: *A business buys a building on January 1, 2002, and meets the RC Business definition during 2002, 2003, 2004, but does not meet the definition in 2005 and 2006 (because, e.g., the number of RC resident employees falls below the 35 percent threshold). The business sells the property in 2007 after holding it five years. The business may not claim the zero percent capital gains tax rate on the profits because the property was not used by an RC Business during substantially all of the taxpayer's holding period. Although "substantially all" is not defined for this purpose, it seems clear that qualifying as an RC business for only 3 of 5 years would not be considered "substantially all" of the taxpayer's holding period.*

Question C.6: If the asset is sold before the end of the five-year period, can the zero percent gain incentive be preserved for the subsequent holder?
Answer: A subsequent purchaser of an asset that otherwise qualifies for zero percent capital gain treatment is eligible for the incentive if the asset continues to qualify and the purchaser purchases it before January 1, 2010, and holds the asset for the minimum five year period. The original purchaser would not be able to exclude any gain attributable to the period the asset was held, however, because that original purchaser did not hold the asset for the minimum period.

Question C.7: What if the asset is held beyond the RC designation period?
Answer: The five-year holding period must commence in the January 1, 2002, to December 31, 2009, period, and thus a taxpayer who acquires a qualifying asset in 2009 can take advantage of the zero capital gain incentive if the asset is held through 2014. However, the zero percent rate applies only to gain attributable to the period after January 1, 2002, and before December 31, 2009. The taxpayer is not required to sell the asset in 2009, but must determine and substantiate the gain attributable to the qualifying period and may apply the zero percent rate to that amount. Any gain that is obtained after December 31, 2009, is subject to taxation.

Question C.8: What if the stock or partnership interest is redeemed before the end of the minimum holding period?
Answer: The asset would not be eligible for the zero percent capital gains rate.

Question C.9: To qualify for the zero percent capital gains rate, what percentage of a business's gross income must come from the active conduct of business within the Renewal Community?
Answer: For Renewal Community businesses, at least 50 percent of gross income must come from the active conduct of business within the RC. That does not mean that the customers or products of the business must come from the RC. Rather, it means that the business must perform its business in the RC.
For the purposes of determining what is gross income, this income would be the same figure that a business would use for other federal tax purposes.

D. COMMERCIAL REVITALIZATION DEDUCTION

Question D.1: Is the CR Deduction available only for new construction?

Answer: The deduction is calculated on the basis of qualifying Commercial Revitalization Expenditures (CREs). CREs include the depreciable costs of a new building or the costs associated with an existing building that is substantially rehabilitated. Substantial rehabilitation means that, within a 24-month period, rehabilitation expenditures exceed the lesser of the adjusted basis of the building (and its structural components) or $5,000. For purposes of determining whether a building has been substantially rehabilitated, rehabilitation expenditures do not include enlarging a building. If the substantial rehabilitation test is met (without taking into account the costs of expansion), the cost of expanding the building could qualify as a CRE.
Example: *You own a building in the Renewal Community that is used for business purposes. You invest $500,000 to rehabilitate the building and the State allocates to you the full $500,000 for the Commercial Revitalization Deduction. At your election, you may deduct $250,000 from your gross revenue for the tax year in which the building is placed back into service, with the remaining $250,000 depreciated over the following 38 years. Alternatively, you may depreciate the full $500,000 over the next ten years beginning from the month in which the building's rehabilitation is completed.*

Question D.2: To what extent do building acquisition costs qualify for the CR Deduction?
Answer: A taxpayer can include the cost of the building acquisition in taking a CR Deduction, but only to the extent that the acquisition cost does not exceed 30 percent of the aggregate qualifying CREs (determined without regard to the acquisition cost).
Example: *If the building costs $500,000 to acquire and renovations eligible for CREs are $1 million, up to $300,000 of the acquisition cost could qualify as a CRE.*

Question D.3: Could an investor obtain special tax advantages for land speculation in an RC?
Answer: The CR Deduction is permitted only for the cost of acquiring a building and rehabilitating it, not for land costs. Acquisition of land for speculation would not qualify.

Question D.4: A business can exercise one of two options for taking an allocation of CR Deduction for its qualified revitalization expenditures: 1.) a 50 percent write-off in the first year, or 2.) a 100 percent write-off over 10 years. Is the second option limited to the $10.0 million per project cap, or can a business depreciate its entire qualified revitalization expenditure over the 10-year period?
Answer: Under either method, the company cannot take accelerated deductions in excess of the amount allocated to the building by the State (or $10 million, whichever is less). The remaining expenditures must be capitalized and depreciated under the applicable MACRS recovery period (generally 39 years).

Question D.5: Is the depreciation schedule for the ten-year CR Deduction based on straight-line accounting?
Answer: Yes. The deduction is allowed ratably over a 120-month period.

Question D.6: May a business in the RC take both the CR Deduction and the tax credits available for the rehabilitation of historic buildings?
Answer: Yes. However, the expenditure figures for the rehabilitation credit are different from

those that must be used to determine the CR Deduction. It is important to consult your tax advisor to claim both.

<u>Question D.7</u>: **Can the CR Deduction apply to mixed-use buildings? If so, what is the amount of residential space allowed, and are there any other limits on the uses?**
<u>**Answer**</u>**:** The CR Deduction applies to any nonresidential real property. Nonresidential real property is any real property other than: 1.) residential rental property, or 2.) property with a class life of less than 27.5 years. Residential rental property is a building or structure for which at least 80 percent of the gross rental income is rental income from dwelling units. Therefore, if less than 80 percent of a building's gross rental income is rental income from dwelling units, the building qualifies for the CR Deduction.

<u>Question D.8</u>: **In a mixed-use project eligible for the CR Deduction (because less than 80 percent of the gross rental income is rental income from dwelling units), are all capital expenses eligible or only the expenses from construction or rehabilitation of the commercial component of the property?**
<u>**Answer**</u>**:** The rules that apply to commercial buildings also apply to mixed-use buildings that meet the "less than 80 percent" test because both are considered "nonresidential real property." Thus, no allocation must be made between the residential portion and the commercial portion.

<u>Question D.9</u>: **If a business has a net operating loss as a result of using the CR Deduction, is it treated in the same manner as a net operating loss under other provisions of the tax code?**
<u>**Answer**</u>**:** Yes.

<u>Question D.10</u>: **When a business determines its federal taxable basis after claiming the RC Deduction, is that taxable basis carried over for the purpose of State taxes?**
<u>**Answer**</u>**:** No, unless the State adopts parallel tax provisions. The RC law does not compel states to do so.

<u>Question D.11</u>: **To claim a CR Deduction, a business must receive an allocation from the State. What is the application process?**
<u>**Answer**</u>**:** A State law (SB 2010, Alpert) was passed on August 30 that mandates that the State adopt a Commercial Revitalization Deduction Allocation Plan prior to the end of the calendar year. The State Treasurer's Office is responsible under this law for preparing the allocation plan. Until the plan is formally adopted and the procedures are published, businesses are advised to submit an allocation request to the San Diego RC program manager.

<u>Question D.12</u>: **The CR Deduction can be claimed only after a project is placed into service. For the purpose of applying to the State Treasurer's Office for a CR Deduction allocation, must actual costs be used or may an allocation be based on estimated costs? If the estimated costs of a proposed project are used, how would any discrepancies between actual qualifying expenses versus estimated qualifying expenses be reconciled?**
<u>**Answer**</u>**:** The statute does not require that allocations be based on either actual or estimated costs. Allocations must be made pursuant to a qualified allocation plan approved by the State, adopted after a public hearing and following reasonable public notice. The allocation plan may

use criteria that are appropriate to the State's and each RC's situation.

Question D.13: If the State Treasurer's Office allocates $8 million to a project, does the entire $8 million count against the total available allocation for that year, regardless of the deduction method used by the business (i.e., 50 percent in the first year versus 10 percent over 10 years), or must the amount of CR Deduction allocation for the next year be reduced by the amount and deduction method used by the business in the RC the previous year?
Answer: The entire $8 million counts against the State's available allocation in the year in which the allocation is made. The amount or method chosen by the business to claim the CR Deduction has no effect on the amount of the allocation for any subsequent year.

Question D.14: For a business to claim the Commercial Revitalization Deduction, the State must allocate the Deduction no later than the end of the calendar year in which a building is placed in service. Must the building be placed in service in the year in which the allocation is made? What about early allocations? Can the State allocate the CR Deduction for a project that may not be placed in service until a future calendar year?
Answer: The California Treasurer's Office can allocate the CR Deduction any time beginning in 2002, so long as it does so pursuant to an allocation plan adopted through a public hearing process and so long as the local jurisdiction in which the allocation would be used is provided an opportunity to comment on the allocation. If an allocation is made in calendar year 2002, then the building must be placed into service by December 31, 2002; alternatively, the building may be placed into service no later than December 31, 2004 so long as the taxpayer's basis in the project in which the building is a part, as of six months after the allocation is made, is at least 10 percent of the taxpayer's reasonably expected basis in the project as of the end of 2004. (See IRC Section 42(h)(1).) However, if the building cannot meet either deadline, the State Treasurer's Office may make a binding commitment, in the form of a contract signed by both parties, to allocate a specified dollar amount to the building in a specified later tax year. In that case, the building need not be placed into service until the end of the specified tax year (which can be no later than the end of 2009). An allocation made through a binding commitment is NOT considered an allocation for the year in which it is made, but rather counts against the allocation for the year in which it must be used. An allocation made through a binding commitment does NOT count against the current year's allocation ceiling. (See IRC Section 42(h)(1)(C).)

Question D.15: If the State's total of CR Deductions is not allocated in any given year, can the unused deductions carry forward for allocation in the next year?
Answer: No.

Question D.16: If a CR Deduction allocation is made for a project that is never put into service, can the unused allocation be reallocated?
Answer: No.

Question D.17: How will the State Treasurer's Office monitor and enforce its CR Deduction allocation decisions?

Answer: The RC law delegates to states the responsibility of establishing an allocation process that is similar to the allocation of low-income housing tax credits. However, unlike the low-income housing tax credit process, there is no monitoring and enforcement requirement imposed under the RC law. The CR Deduction is a taxpayer compliance matter and could be raised during an audit of the taxpayer's tax return. The State Treasurer's Office may, but is not required to, establish a monitoring and compliance process, such as the enforcement of any binding commitments.

Question D.18: What other tax consequences arise from using the CR Deduction?
Answer: No depreciation is allowed for amounts deducted as the CR Deduction. The adjusted basis of the building is reduced by the amount of the CR Deduction, and the deduction is treated as a depreciation deduction in applying the depreciation recapture rules.

Question D.19: Can the CR Deduction apply to construction that started before January 1, 2002?
Answer: Yes, provided an allocation was made to the building not later than December 31 of the calendar year the building was placed in service.

Question D.20: What forms are required to claim the Commercial Revitalization Deduction?
Answer: If the 50 percent deduction is claimed, it will be claimed under "other deductions" or "other expenses" on the taxpayer's income tax return or business schedule (e.g., Schedule C). If amortization over a 120-month period is claimed, the deduction is claimed on line 42 of Form 4562 (for the first tax year) and also on the "other deductions" or "other expenses" line of the taxpayer's income tax return or business schedule. For partnerships and "S" corporation shareholders, the deduction will be included in the net income or loss claimed in Part II of Schedule E (Form 1040). Form 8582 must also be used to claim the special $25,000 allowance if the CR Deduction is from a passive rental real estate activity. The $25,000 allowance for the CR Deduction applies to all taxpayers regardless of their AGI.

E. RENEWAL COMMUNITY BUSINESS ELIGIBILITY

Question E.1: Can real estate professionals qualify as Renewal Community businesses?
Answer: Yes, provided the property owned by the real estate professional is not residential rental
property and at least 50 percent of the gross rental income from the lessees is from Renewal Community businesses. Note that property is residential rental property only if 80 percent or more of the gross rental income from the property is from dwelling units.

Question E.2: Can a bank, located in an RC with more than 35 percent of its employees being RC residents and doing more than 50 percent of its business in the RC, meet the definition of an RC business, given the requirement that less than 5 percent of the aggregate adjusted bases of the property of the business be attributable to "non qualified financial property"?
Answer: No, unless less than 5 percent of the bank's average aggregate unadjusted bases are attributable to nonqualified financial property. Nonqualified financial property includes debt and

other similar property (other than accounts or notes receivable from sales or services).

Question E.3: Do family members count as "employees" in determining if the business is considered a Renewal Community Business? For example, if a business located in the Renewal Community has ten employees, four of whom are family members who live in the RC, how many employees need to live in the RC in order to be considered a Renewal Community Business? Would it be 35 percent of 10 employees or 35 percent of 6 employees?
Answer: Yes, employees who are also family members count for purposes of the 35 percent test. So, in the example, the test would be based on the 10 employees, and the 4 who are family members who reside in the RC would meet the business's 35 percent requirement. Note, however, family members are not eligible for a business to claim the RC Wage Credit (see Question A.6. above).

Question E.4: If the percentage of a company's RC residents is some fraction less than 35 percent, e.g., 15 of 43 employees, which equals 34.88 percent, must the number be rounded up or down to determine whether the business qualifies as an RC business?
Answer: Neither. The law does not allow for rounding the number. At least 35 percent of the employees must be residents of a Renewal Community. For any percentage less than 35 percent, the employer would fall below the threshold and would fail to meet the test.

Question E.5: To qualify as an RC business, based on the percentage requirements, can investments and employees be in multiple designated RCs?
Answer: Yes.

Question E.6: Can national or international firms with numerous sites take advantage of RC tax savings if they have a facility in an RC?
Answer: To meet the various percentage requirements and thereby qualify as a Renewal Community business, a large business can set up a separate legal entity (e.g., a subsidiary or partnership). Activities of legally separate, even if related, parties are not aggregated for purposes of determining whether an entity qualifies as a Renewal Community business.

Question E.7: RC designations are based on 1990 Census Tract data. If a major employer's address is in the RC, but the firm has several adjacent buildings that are physically located outside the RC, simply by the demarcation lines of the census tract, can the employer be considered to be inside the RC?
Answer: If a business uses real property located both within and outside an RC, and the amount of the real property located within the RC is "substantial" when compared to the amount of the real property located outside the RC and is contiguous to the real property within the RC, the contiguous property is treated as being within the RC. However, this rule applies only for purposes of defining a "Renewal Community business." Employees who work in the contiguous buildings may not meet other tests pertaining to RC Wage Credits or the 35 percent RC resident requirement.

Question E.8: Must the employers and employees that use the Renewal Community tax incentives be residents of the United States?

Answer: For purposes of figuring the RC credits and deductions, neither the owner nor the employees are required to be U.S. citizens.

Question E.9: When will the IRS tax forms be ready to claim the RC tax incentives?
Answer: The IRS is developing these forms and plans to release them in late 2002. Drafts (subject to change) of the 2002 forms are available for viewing on the Internet at: www.irs.gov/bus_info/tax_pro/dftform2.html.

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