

Tax Tips

By Sidney Kess

New Tax Rules in the Housing and Economic Recovery Act

Before Congress recessed for its summer vacation, it enacted a major new law, the Housing and Economic Recovery Act (P.L. 110-289), designed to rescue the ailing housing market. There are about \$15 billion in incentives, only some of which are offset by revenue raisers. President Bush signed the measure into law on July 30 and some of the provisions are effective immediately. Here are the key tax changes under the new law (referred to as the "Housing Act").

First-time homebuyer credit

To encourage people to buy homes in what has come to be the worst housing market since the Great Depression, the new law offers eligible taxpayers a refundable tax credit (Code Sec. 36). The credit is limited to the lesser of \$7,500 (or \$3,750 for a married person filing separately), or 10% of the purchase price of the home.

The credit can only be used for the purchase of a principal residence; it cannot be used when buying a vacation home.

The credit is limited to homebuyers whose income does not exceed a set limit. The credit phases out for singles with modified adjusted gross income between \$75,000 and \$95,000. The phase-out range for married persons filing jointly is \$150,000 to \$175,000.

A taxpayer is treated as a first-time homebuyer if he or she had no ownership interest in a principal residence in the U.S. during the three-year period prior to the purchase of the current home.

The credit is merely a loan that must be repaid to the federal government, without any interest. The payback is ratably over a period of 15 years starting in the second year after the purchase. For instance, if a taxpayer claims the credit for a home purchased in 2008, the payback period starts with the taxpayer's 2010 income tax return. There are, however, certain variations to the payback rule.

- The payback ceases if the homeowner dies. Heirs who inherit the home do not have to pay any remaining credit back.
- The payback accelerates if the homeowner sells the residence before completing the 15-year payback period. Thus, if the homeowner buys the home on January 1, 2009, and sells on January 1, 2012, after only one year of repayment (which starts on January 1, 2011), 14/15ths are repaid in 2012, the year of sale. However, the payback cannot exceed the gain from the sale of the residence. For purposes of figuring gain, the adjusted basis of the home is determined by reducing the basis by the amount of the credit that has not previously been recaptured.
- The payback is not accelerated if the home suffers an involuntary conversion and is replaced with another principal residence within two years.

- The payback becomes the responsibility of the transferee-spouse who receives the home incident to divorce.

The credit applies only to a home purchased on or after April 9, 2008, and before July 1, 2009. Having a binding contract to purchase the home prior to April 9, 2008, will not void the credit as long as the closing is within the qualified period. Similarly, having a binding contract to purchase the home in place on June 30, 2009, will not make the homeowners eligible for the credit; they did not close before the end of the eligibility period.

An election can be made for a home purchased within the qualified period in 2009 to claim the credit on the 2008 return. This will also fix the start of the recapture period. If the 2008 return has been filed before claiming the credit, an amended return can be filed to accelerate the credit to 2008.

Additional standard deduction for real estate taxes

Until now, homeowners could deduct property taxes only if they itemized their personal deductions. Under the Housing Act (Code Sec. 63(c)(7)), they can increase their standard deduction to account for property taxes.

The additional standard deduction amount is limited to the lesser of amount that could have been claimed as an itemized deduction, which is essentially the taxes paid with respect to a principal residence or designated second home, or \$500 for singles, \$1,000 on a joint return.

This new break applies only for 2008 returns. There is no AGI limit for claiming this additional standard deduction amount. However, as a practical

matter, taxpayers with higher AGI usually have enough personal deductions to itemize.

This break will benefit such taxpayers as seniors who have already paid off their mortgage and may not have sufficient personal deductions to itemize. Seniors (those age 65 and older) already enjoy an additional standard deduction because of age (\$1,050 for married persons and \$1,350 for singles in 2008). This is in addition to the basic standard deduction amount of \$10,900 for married filing jointly, \$8,000 for heads of household, and \$5,450 for singles and surviving spouses). For example, a single person, age 66, who owns a home could take total standard deduction of \$7,300 ($\$5,450 + \$1,350 + \500).

Tax credits

The low-income housing credit has been expanded, increased, and simplified (Code Sec. 42). States and local housing authorities can issue tax credits for the acquisition, rehabilitation or construction of low-income rental housing, starting this year. The current cap per resident has been upped to \$2.20 from \$2. And some of the complex rules have been simplified.

A C corporation can opt to accelerate the AMT and research credits in lieu of claiming 50% bonus depreciation. This option applies to tax years ending after March 31, 2008.

Alternative minimum tax

The low-income housing credit can be used to offset alternative minimum tax liability. This applies to the credit for housing placed in service after December 31, 2007.

The rehabilitation credit can also be used to offset alternative minimum tax liability. This applies to expenditures taken into account after December 31, 2007.

Also, housing bonds that are private activity bonds are not a tax preference for purposes of the alternative minimum tax.

Restriction on home sale exclusion

Gain on the sale of a principal residence is excluded from gross income up to \$250,000, or \$500,000 on a joint return, if the seller has owned and lived in the home for at least two of the five years preceding the date of sale (Code Sec. 121).

Under the Housing Act, the portion of gain on the sale of a home allocated to periods of "nonqualified use" cannot be sheltered by the exclusion. The rule that applies for any period on or after January 1, 2009.

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"Nonqualified use" means any use by the taxpayer or spouse as other than a principal residence, which includes use of a home as vacation or rental property. Temporary absences because of a change in employment, health, or unforeseen circumstances are not considered periods of nonqualified use. Similarly, if the home remains vacant after the taxpayer relocates to another home, this will not affect the exclusion.

The amount of gain allocated to periods of nonqualified use is the total gain multiplied by a fraction, the numerator of which is the aggregate periods of nonqualified use and the denominator is the total period of ownership of the home.

The Joint Committee on Taxation offers this example: An individual buys a home on January 1, 2009, for \$400,000 and uses it as rental property for two years, claiming \$20,000 of depreciation deductions. On January 1, 2011, he converts the property to his principal residence. On January 1, 2013, he moves out; he sells the home on January 1, 2014, for \$700,000. He clearly satisfies the two-year ownership and use tests. The \$20,000 of depreciation is recaptured, as under current law. However, of the remaining \$300,000 gain, 40% of it is attributable to a nonqualified use; during the five years that the home was owned, it was used as rental property for two years. Thus, \$120,000 of the gain does not qualify for the exclusion. The balance of the gain, or \$180,000, qualifies for the exclusion. Since this is less than the owner's \$250,000 exclusion limit, all of this part of the gain is excludable; the \$120,000 is taxable.

This law change can have a serious tax impact on those nearing retirement who buy a second home and plan to move there full time when they retire. Until now, the home sale exclusion could have been used to shield the gain on the main home; this may not be possible, depending on the timing of the sale and other factors.

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The new nonqualified use rule only applies to sales after December 31, 2008, and takes into account only nonqualified use after this date.

Credit card reporting

Starting in 2011, financial institutions will be required to report to the IRS annual credit and debit card transactions (including PayPal transactions) (Code Sec. 6050W). This measure is designed to help close the “tax gap,” which is the spread between what the government collects and what it believes it should be collecting.

Merchants’ transactions will be exempt from this reporting only if there are 200 or fewer annual transactions or total transactions do not exceed \$20,000 for the year.

Presumably, before this effective date, the IRS will provide guidance on the impact of chargebacks and other situations so that information reporting will properly reflect the income that a merchant receives via credit or debit cards.

Corporate estimated taxes

Large corporations (those with assets over \$1 billion) will have to accelerate certain corporate estimated tax payments. Payments due in July, August, and September 2013 will have to be at least 116.75% of the usual payment amount to avoid penalty.

Accelerated payments that had been scheduled for 2012 (as well as prior increases for 2013) have been repealed.