



Home Run: Selected Tax Provisions in the Housing Bill  
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## **Housing and Taxes**

With the building crisis related to mortgages and housing, the Congress and the President came to terms on the *American Housing Rescue and Foreclosure Prevention Act of 2008*, with the Senate giving their blessing to the bill in a rare Saturday morning session. While the law contains a number of provisions in many areas of the law, we are mainly concerned today with certain tax provisions that will affect those of us practicing in tax matter with individual and closely held business clients.

Like most tax bills, this one contains both new taxpayer friendly provisions and less taxpayer friendly revenue offsets. While we won't cover all items in the bill (I won't spend time on the new provisions in areas like the low income housing credit, tax exempt housing bonds, mortgage revenue bonds and REITs) we will look in some detail at areas I think will be of special interest to practices like mine that deal with individuals and closely held businesses.

## First, the Good News

It's always best to start out with those things that are breaks individuals will like, and Congress understands that—so we see a number of taxpayer friendly provisions first in the bill. Most of the breaks are geared to deal with encouraging home purchases by individuals who are not currently homeowners, but also has a break for corporations that might not see a benefit from the enhanced depreciation provisions effective this year due to showing losses, but who have substantial unused minimum tax credit carryovers—a group that likely includes many construction corporations.

### First Time Homeowner Credit

The new law provides for a refundable credit available to “first time” homeowners. That provision, found in Act §612 and reads as follows:

SEC. 612. FIRST-TIME HOMEBUYER CREDIT.

(a) In General- Subpart C of part IV of subchapter A of chapter 1 is amended by redesignating section 36 as section 37 and by inserting after section 35 the following new section:

SEC. 36. FIRST-TIME HOMEBUYER CREDIT.

(a) Allowance of Credit- In the case of an individual who is a first-time homebuyer of a principal residence in the United States during a taxable year, there shall be allowed as a credit against the tax imposed by this subtitle for such taxable year an amount equal to 10 percent of the purchase price of the residence.

(b) Limitations-

(1) DOLLAR LIMITATION-

(A) IN GENERAL- Except as otherwise provided in this paragraph, the credit allowed under subsection (a) shall not exceed \$7,500.

(B) MARRIED INDIVIDUALS FILING SEPARATELY- In the case of a married individual filing a separate return, subparagraph (A) shall be applied by substituting '\$3,750' for '\$7,500'.

(C) OTHER INDIVIDUALS- If two or more individuals who are not married purchase a principal residence, the amount of the credit allowed under subsection (a) shall be allocated among such individuals in such

manner as the Secretary may prescribe, except that the total amount of the credits allowed to all such individuals shall not exceed \$7,500.

So we start out with a credit equal to 10% of the purchase price of the residence, not to exceed \$7,500, except in the case of a married couple filing a separate return. In that case, the limit is ½ of the total. Note, as well, that there is a special provision that applies to individuals who are not married—they will be able to split it in the “manner the Secretary may prescribe” but not to exceed \$7,500 between the two.

Now, like all breaks Congress enacts, this one is subject to its own phase out, as we continue on in new §36(b)(2):

“(2) LIMITATION BASED ON MODIFIED ADJUSTED GROSS INCOME-

“(A) IN GENERAL- The amount allowable as a credit under subsection (a) (determined without regard to this paragraph) for the taxable year shall be reduced (but not below zero) by the amount which bears the same ratio to the amount which is so allowable as--

“(i) the excess (if any) of--

“(I) the taxpayer's modified adjusted gross income for such taxable year, over

“(II) \$75,000 (\$150,000 in the case of a joint return), bears to

“(ii) \$20,000.

“(B) MODIFIED ADJUSTED GROSS INCOME- For purposes of subparagraph (A), the term ‘modified adjusted gross income’ means the adjusted gross income of the taxpayer for the taxable year increased by any amount excluded from gross income under section 911, 931, or 933.

So as “modified” AGI goes above \$75,000 (or \$150,000 for a married couple filing a joint return), the benefit begins to phase out, with it going away entirely at \$95,000 or \$170,000.

Definitions, as always, are key to understanding the statute. And, as before, Congress tells that a “first time homebuyer” isn't necessarily someone who has never owned a home (or even, interestingly, someone who doesn't currently own a home). New §36(c)(1) provides:

(c) Definitions- For purposes of this section--

`(1) FIRST-TIME HOMEBUYER- The term `first-time homebuyer' means any individual if such individual (and if married, such individual's spouse) had no present ownership interest in a principal residence during the 3-year period ending on the date of the purchase of the principal residence to which this section applies.

Note this is not the same definition we find that applies to §72(t)(2)(F) exception to the 10% tax on premature distributions from an IRA, though it is similar. §72(t)(8)(D) provides a two year, not three year, test for that exception. So it's possible to qualify for the 10% relief but not get the credit. As for why Congress decided on this seemingly bizarre difference, it was most likely to get the budget scoring they needed for the bill.

The good news is that the same definition is used for principal residence as is used for §72(t)(2)(F)'s definition, with §36(c)(2) providing:

`(2) PRINCIPAL RESIDENCE- The term `principal residence' has the same meaning as when used in section 121.

Thus, for the Section 121 definition of what is a principal residence still is controlling.

The definition of the term “purchase” is used to introduce some additional restrictions:

`(3) PURCHASE-

`(A) IN GENERAL- The term `purchase' means any acquisition, but only if--

`(i) the property is not acquired from a person related to the person acquiring it, and

`(ii) the basis of the property in the hands of the person acquiring it is not determined--

`(I) in whole or in part by reference to the adjusted basis of such property in the hands of the person from whom acquired, or

`(II) under section 1014(a) (relating to property acquired from a decedent).

`(B) CONSTRUCTION- A residence which is constructed by the

taxpayer shall be treated as purchased by the taxpayer on the date the taxpayer first occupies such residence.

Note that “purchase” doesn't mean purchase, but rather any acquisition with two carve outs. The first is for any property acquired from a related person, a term later defined, or one those acquired via gift (or any other acquisition where basis is determined in whole or in part by the basis of the prior owner) or from a decedent via §1014(a).

As well, note that if taxpayer enters into a contract to have a residence constructed, it is the date the taxpayer occupies the residence that will count under these rules. That becomes important because, as we will note later, this provision is scheduled to be leaving the law in less than a year.

Purchase price is defined at §36(c)(4):

`(4) PURCHASE PRICE- The term `purchase price' means the adjusted basis of the principal residence on the date such residence is purchased.

Related persons is the final term that is defined, found at §36(c)(5):

`(5) RELATED PERSONS- A person shall be treated as related to another person if the relationship between such persons would result in the disallowance of losses under section 267 or 707(b) (but, in applying section 267(b) and (c) for purposes of this section, paragraph (4) of section 267(c) shall be treated as providing that the family of an individual shall include only his spouse, ancestors, and lineal descendants).

The provision borrows the general related party definitions found in §§267 and 707(b), but the family definition in §267(c)(4) is modified to remove the reference to brothers and sisters—so a person's sibling can be the prior owner of the property in question, although spouses, ancestors (such as parents and grandparents) and descendents (such as children and grandchildren) will be off limits.

§36(d) provides for four exceptions to the credit:

`(d) Exceptions- No credit under subsection (a) shall be allowed to any taxpayer for any taxable year with respect to the purchase of a residence if--

`(1) a credit under section 1400C (relating to first-time homebuyer in the District of Columbia) is allowable to the taxpayer (or the taxpayer's spouse) for such taxable year or any prior taxable year,

`(2) the residence is financed by the proceeds of a qualified mortgage issue the interest on which is exempt from tax under section 103,

`(3) the taxpayer is a nonresident alien, or

`(4) the taxpayer disposes of such residence (or such residence ceases to be the principal residence of the taxpayer (and, if married, the taxpayer's spouse)) before the close of such taxable year.

Section 103 refers to interest on state and local bonds. The other exemptions are fairly self-explanatory—the taxpayer can't “double dip” with District of Columbia credit, can't be a nonresident alien and has to still have and be using this principal residence at the end of the year in question.

The information reporting exception for sales of homes allowed under §6045(e)(5) is addressed next, being potentially pulled for homes where the credit may be involved:

`(e) Reporting- If the Secretary requires information reporting under section 6045 by a person described in subsection (e)(2) thereof to verify the eligibility of taxpayers for the credit allowable by this section, the exception provided by section 6045(e) shall not apply.

However, what Congress gives Congress later gets back in this case—taxpayers aren't allowed to “keep” the credit but instead must pay it back. How fast that payback takes place depends on whether the taxpayer retains the residence in question. In general, §36(f)(1) establishes a 15 year payback period:

`(f) Recapture of Credit-

`(1) IN GENERAL- Except as otherwise provided in this subsection, if a credit under subsection (a) is allowed to a taxpayer, the tax imposed by this chapter shall be increased by 6 2/3 percent of the amount of such credit for each taxable year in the recapture period.

And, although we're taking it out of order, jumping to §36(f)(7) we find what the “recapture period” is:

`(7) RECAPTURE PERIOD- For purposes of this subsection, the term “recapture period” means the 15 taxable years beginning with the second taxable year following the taxable year in which the purchase of the principal residence for which a credit is allowed under subsection (a) was made.

So if a credit is allowed for 2008, then the recapture period would begin in 2009 and continue on for 15 years, presuming earlier repayment is an exception isn't triggered.

As you might expect, disposing of the residence will accelerate the repayment of the credit. §36(f)(2) provides:

`(2) ACCELERATION OF RECAPTURE- If a taxpayer disposes of the principal

residence with respect to which a credit was allowed under subsection (a) (or such residence ceases to be the principal residence of the taxpayer (and, if married, the taxpayer's spouse)) before the end of the recapture period--

`(A) the tax imposed by this chapter for the taxable year of such disposition or cessation, shall be increased by the excess of the amount of the credit allowed over the amounts of tax imposed by paragraph (1) for preceding taxable years, and

`(B) paragraph (1) shall not apply with respect to such credit for such taxable year or any subsequent taxable year.

In general, disposing of the residence triggers repayment of the remaining amount that had not already been repaid under the general rule cited above. But there are limitations and exceptions. The first one involves capping the recapture to the gain on sale, after reducing the basis in the residence by any previously unrecaptured gain:

`(3) LIMITATION BASED ON GAIN- In the case of the sale of the principal residence to a person who is not related to the taxpayer, the increase in tax determined under paragraph (2) shall not exceed the amount of gain (if any) on such sale. Solely for purposes of the preceding sentence, the adjusted basis of such residence shall be reduced by the amount of the credit allowed under subsection (a) to the extent not previously recaptured under paragraph (1).

Thus, a taxpayer that finds he has to dispose of the property at a significant loss would not have to pay off the credit at disposition—but if the taxpayer continues to hold the property, then repayments would still continue.

As well, there are general exceptions to the recapture rule. The first one is an event that solves lots of tax problems—the death of the taxpayer:

`(4) EXCEPTIONS-

`(A) DEATH OF TAXPAYER- Paragraphs (1) and (2) shall not apply to any taxable year ending after the date of the taxpayer's death.

Note that, as we'll show later, each spouse is deemed to be allocated  $\frac{1}{2}$  of the credit if it is claimed on a joint return, so the death of one spouse would appear to trigger relief on half of the credit not previously recaptured.

Involuntary conversions also don't trigger repayment, however the “taint” carries over to the new property and recapture continues:

`(B) INVOLUNTARY CONVERSION- Paragraph (2) shall not apply in the case

of a residence which is compulsorily or involuntarily converted (within the meaning of section 1033(a)) if the taxpayer acquires a new principal residence during the 2-year period beginning on the date of the disposition or cessation referred to in paragraph (2). Paragraph (2) shall apply to such new principal residence during the recapture period in the same manner as if such new principal residence were the converted residence.

Finally, in the case of a divorce or other transfers between spouses, recapture is not triggered for the “out of house” spouse, but rather that problem and liability for repayment carries over to the spouse that retains the property:

“(C) TRANSFERS BETWEEN SPOUSES OR INCIDENT TO DIVORCE- In the case of a transfer of a residence to which section 1041(a) applies--

“(i) paragraph (2) shall not apply to such transfer, and

“(ii) in the case of taxable years ending after such transfer, paragraphs (1) and (2) shall apply to the transferee in the same manner as if such transferee were the transferor (and shall not apply to the transferor).

Note that nothing in the provision requires that the property have been acquired when the couple was married—thus, if one spouse came into the marriage with this taint and later, at the divorce, the other spouse got the property, the other person would now be liable to repay the credit that had originally gone to their former spouse on the return filed when that person was single.

The joint return split is found in §36(f)(5) which provides:

“(5) JOINT RETURNS- In the case of a credit allowed under subsection (a) with respect to a joint return, half of such credit shall be treated as having been allowed to each individual filing such return for purposes of this subsection.

Finally, a “loose end” was tied down by §36(f)(6) which requires a taxpayer to file a return even if generally not otherwise required to file a return for those years. It provides:

“(6) Return requirement.--If the tax imposed by this chapter for the taxable year is increased under this subsection, the taxpayer shall, notwithstanding section 6012, be required to file a return with respect to the taxes imposed under this subtitle.

The provision is only effective, as initially written, for a slightly more than one year period—and that period doesn't coincide with the calendar year. Rather, §36(h) provides:

“(h) Application of Section- This section shall only apply to a principal residence purchased by the taxpayer on or after April 9, 2008, and before July 1, 2009.’

A special rule allows a taxpayer who closes in early 2009 to claim the credit on a 2008 return:

(g) Election to Treat Purchase in Prior Year.--In the case of a purchase of a principal residence after December 31, 2008, and before July 1, 2009, a taxpayer may elect to treat such purchase as made on December 31, 2008, for purposes of this section (other than subsection (c)).

The reference to subsection (c) means that you won't go back to December 31, 2008 to meet the three year test for not previously having

## Nonitemizers Real Estate Tax Deduction

A more limited benefit is offered for 2008 only to taxpayers who are unable to itemize deductions but who pay property taxes. For this year, a taxpayer's standard deduction is increased by the amount of property taxes, capped at \$350 (or \$700 for a joint return).

### SEC. 613. ADDITIONAL STANDARD DEDUCTION FOR REAL PROPERTY TAXES FOR NONITEMIZERS.

(a) In General- Section 63(c)(1) (defining standard deduction) is amended by striking 'and' at the end of subparagraph (A), by striking the period at the end of subparagraph (B) and inserting ', and', and by adding at the end the following new subparagraph:

(C) in the case of any taxable year beginning in 2008, the real property tax deduction.'

(b) Definition- Section 63(c) is amended by adding at the end the following new paragraph:

(7) REAL PROPERTY TAX DEDUCTION- For purposes of paragraph (1), the real property tax deduction is the lesser of--

(A) the amount allowable as a deduction under this chapter for State and local taxes described in section 164(a)(1), or

(B) \$350 (\$700 in the case of a joint return).

Any taxes taken into account under section 62(a) shall not be taken into account under this paragraph.'

(c) Effective Date- The amendments made by this section shall apply to taxable years beginning after December 31, 2007.

Note that since this increases the standard deduction, taxpayers won't benefit for alternative minimum tax purposes from this way of deducting real estate taxes, just as they don't benefit from real estate taxes claimed on Schedule A.

## Accelerate AMT and R&D Credits in Lieu of Bonus Depreciation

Taxpayers will be able, per §3081 of the Act, to elect to accelerate the use of alternative minimum tax and research and development credits in lieu of claiming the bonus depreciation allowed for 2008 acquisitions. The credits are refundable up to 20% of the difference between what the bonus depreciation would have been and the depreciation actually claimed, capped at \$30 million or 6% of the credits accumulated from 2005 or earlier years. Thus, it primarily will benefit taxpayers who have large alternative minimum tax carryovers and now find themselves in a loss position.

## Bad News Provisions

Congress now needed to pay for these provisions, and those items are generally not going to be ones our clients will be thrilled with. We will look at one of these in detail, but others that might be of interest include:

- Credit card and other payment reporting—companies processing credit card and other payments (such as PayPal) will be required to report gross proceeds paid to businesses beginning in 2011. There will be a *de minimus* exception for proceeds paid that are less than \$20,000 for a year.
- Corporate estimated tax payments again have games played in order to move money from one budget year to another. Accelerated payments for 2012 are now repealed, but the games are moved to 2013 quarters.

## Reduced Home Sale Exclusion

Congress reduces the availability of a technique some had used to attempt to escape taxation on appreciation of residential real property not initially acquired as a principal residence by now penalizing that period of initial “nonqualifying use” when attempting to use the Section 121 gain exclusion.

The general provision is found at new §121(b)(4) which begins:

“(4) Exclusion of gain allocated to nonqualified use.--

“(A) In general.--Subsection (a) shall not apply to so much of the gain from the sale or exchange of property as is allocated to periods of nonqualified use.

We use a time based allocation system to determine qualified and nonqualified gain, a ratio defined in §121(b)(4)(B) which provides:

`(B) Gain allocated to periods of nonqualified use.--For purposes of subparagraph (A), gain shall be allocated to periods of nonqualified use based on the ratio which--

`(i) the aggregate periods of nonqualified use during the period such property was owned by the taxpayer, bears to

`(ii) the period such property was owned by the taxpayer.

We first hit the general nonqualifying period rule found in §121(b)(4)(C)(i) which provides:

`(C) Period of nonqualified use.--For purposes of this paragraph--

`(i) In general.--The term `period of nonqualified use' means any period (other than the portion of any period preceding January 1, 2009) during which the property is not used as the principal residence of the taxpayer or the taxpayer's spouse or former spouse.

Note that periods through the end of 2008 get “grandfathered” in as qualifying—so the issue starts next year.

As well, certain exceptions apply to the “nonqualified use” periods after January 1, 2009. The first is meant to deal with cases where the taxpayer moves out prior to closing the sale, but still sells the property while meeting the general rule of §121(a). §121(b)(4)(C)(ii)(I) provides:

`(ii) Exceptions.--The term `period of nonqualified use' does not include--

`(I) any portion of the 5-year period described in subsection (a) which is after the last date that such property is used as the principal residence of the taxpayer or the taxpayer's spouse,

The exceptions for certain government service also apply for this purpose. §121(b)(4)(C)(ii)(II) provides:

`(II) any period (not to exceed an aggregate period of 10 years) during which the taxpayer or the taxpayer's spouse is serving on qualified official extended duty (as defined in subsection (d)(9)(C)) described in clause (i), (ii), or (iii) of subsection (d)(9)(A), and

Finally, certain other temporary absences will be excepted as well, though we again have an “unforeseen circumstance” exception. §121(b)(4)(C)(ii)(III) holds:

`(III) any other period of temporary absence (not to exceed an aggregate period of 2 years) due to change of employment, health conditions, or such other unforeseen circumstances as may be specified by the Secretary.

We also have coordination with the depreciation gain recognition provision found in §121(b)(4)(D):

`(D) Coordination with recognition of gain attributable to depreciation.--For purposes of this paragraph--

`(i) subparagraph (A) shall be applied after the application of subsection (d)(6), and

`(ii) subparagraph (B) shall be applied without regard to any gain to which subsection (d)(6) applies."

What those provisions mean is that we first recognize the post-1997 depreciation gain, and that gain won't be subject to proration.