

TAX UPDATE

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Sharing the Credit—IRS Rules on §36 Provision

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The IRS has issued Notice 2009-12 which provides guidance on splitting the first time homebuyer's credit added by the *Housing and Economic Recovery Act of 2008*. One somewhat unusual provision in that credit is the ability for individuals that jointly own and use the property who are not married to split the credit. The IRS granted what most observers see as a very favorable set of rules that allow splitting the credit on very taxpayer favorable terms.

I. Section 36 Credit

The first time homebuyer's credit is found at §36 of the Internal Revenue Code. The provision allows a credit equal to 10% of the purchase price of the residence for a "first-time homebuyer" if the property is used as a principal residence [IRC §36(a)].

A first time homebuyer is defined for purposes of this section to mean an individual who 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" [IRC §36(c)(1)]. And the term "principal residence" is given the same meaning it has for the Section 121 gain exclusion provision [IRC §36(c)(2)]. Other restrictions are imposed on the credit to limit or eliminate the use of the credit for property acquired from certain related parties, property acquired by gift and in certain other cases.

The credit is also phased out and eventually eliminated as income increases. That limit is defined in Section 36(b)(2) which provides:

(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.

Note that a number of other special features apply to this credit we aren't going to deal with in this presentation, such the ability to still apply a credit against your 2008 taxes even if you purchase the home in 2009 before expiration of the provision, and the fact that this credit is really an interest free loan that the recipient ends up paying back over 15 years or when they cease to use the property as their principal residence.

II. The Unmarried Joint Owner Provision

One additional provision is of interest to us today. That is the provision found at §36(b)(1)(C) which provides

(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.

Without this provision, it appears that an unmarried couple would have been eligible for \$15,000 in credit, but the fix left open just how the credit would be split and the IRS left this question unanswered until the issuance of Notice 2009-12.

III. IRS Rules on Splitting the Credit

The “how” of unmarried couples splitting the credit has now been answered by the IRS—and the answers are relatively generous to the taxpayer. In reality they are so generous that the provision amounts to, effectively, a new marriage penalty of sorts since couples that are unmarried may qualify one partner to receive the entire credit when they could not have picked up the entire credit had they been married.

A. Basic IRS Ruling

The actual IRS ruling is rather short on how taxpayers may split the credit. The ruling allows taxpayer to split the credit using “any reasonable method” that they choose to use [Notice 2009-12]. The ruling goes on to define a reasonable method as “any method that does not allocate any portion of the credit to a taxpayer not eligible to claim that portion.” In one sense that is interesting, since it virtually forces the credit onto the eligible partner's return.

We are also told specifically that a reasonable method includes allocating the credit based on the following:

- the taxpayers’ contributions towards the purchase price of a residence as tenants in common or joint tenants
- the taxpayers’ ownership interests in a residence as tenants in common.

B. IRS Examples

The IRS goes on to give seven examples of applying this provision. We will look at each one of those, since they give us some insight into the provision, as well as raise some questions.

1. Example 1 – Uneven Contributions to Purchase Price

The first example considers the issue where the taxpayers make an uneven contribution to the purchase of the residence, but end up with equal ownership interests. The example reads:

A contributes \$45,000 and B contributes \$15,000 towards the

\$60,000 purchase price of a residence. Each owns a one-half interest in the residence as tenants in common. Under § 36(a), the allowable credit is limited to 10 percent of the purchase price, or \$6,000. A and B may allocate the allowable \$6,000 credit three-fourths to A and one-fourth to B based on their contributions toward the purchase price of the residence, one-half to each based on their ownership interests in the residence, or using any other reasonable method (for example, the entire credit to A or B because both A and B are eligible to claim the entire allowable credit).

RIA's daily newsletter noted that what this example doesn't discuss is the issue that it appears a gift took place between the individuals involved. Ignoring the potential gift tax aspect of this, it appears the IRS is effectively ruling that this transfer does not cause loss of the credit under the limitation at §36(c)(3)(ii) that generally prevents use of the credit if you acquire the property via gift.

However, as the example 3 makes clear, it's also possible to lose this treatment.

2. **Example 2 – One Party Makes Down Payment, Both Liable on Mortgage**

The second example covers the case where one party has the case for the down payment, but both parties end up on the mortgage. That case also gives us wide latitude in dividing the credit.

A contributes \$10,000 for a down payment towards the \$100,000 purchase price of a residence, and A and B obtain and are jointly liable for a \$90,000 mortgage for the remainder of the purchase price. Each owns a one-half interest in the residence as tenants in common. Under § 36(b)(1)(A), the allowable credit is not \$10,000 (10 percent of the purchase price) but is limited to \$7,500. A and B may allocate the allowable \$7,500 credit 55 percent to A and 45 percent to B based on their contributions toward the purchase price, one-half to each based on their ownership interests in the residence, or using any other reasonable method (for example, the entire credit to A or B because both A and B are eligible to claim the entire allowable credit).

Again, we are not required to have the majority of the credit go to A even though A supplied more consideration than did B—the gift issue simply is not considered in the ruling.

3. Example 3 – One Party Purchases Then Later Sells Interest to Partner

Sometimes it's "easier" (due to credit problems or other issues) for one party to qualify by themselves to purchase the residence and then, outside of the closing, have the other party pay for their share of the residence. However, this example indicates that may create a problem.

On April 15, 2008, A pays the entire \$100,000 purchase price of a residence and is the sole owner. Under § 36(b)(1)(A), the allowable credit is not \$10,000 (10 percent of the purchase price) but is limited to \$7,500. On May 12, 2008, A transfers a one-half interest in the residence to B as a tenant in common for \$10,000. A may claim the entire allowable \$7,500 credit. Because B acquired B's interest in the residence from A in part by gift, B's basis in the residence is determined under § 1015 by reference to A's basis in the residence. Therefore, B did not purchase an interest in the residence within the meaning of § 36(c)(3), and no portion of the credit may be allocated to B because B is not eligible to claim any portion of the credit.

Now, suddenly, the gift issue arises in this example. One key factor to note here is that there was a passage of some time before the transfer to B in this example—that suggests that perhaps if the second transfer took place on the same date as closing there might be a different result (arguing it was a single transaction and therefore more like example 1). However, at this point that is simply speculation.

What is clear is that the safest route is going to be to have all parties participate in the closing who are going to be claiming the credit.

4. Example 4 – One Owner Not a First Time Homebuyer

In example 4 we have the issue where one of the two partners is not a first time homebuyer under the law.

A and B each contributes \$50,000 towards the \$100,000 purchase price of a residence and owns a one-half interest in the residence as tenants in common. Under § 36(b)(1)(A), the allowable credit is not \$10,000 (10 percent of the purchase price) but is limited to \$7,500. However, B is not a first-time homebuyer

within the meaning of § 36(c)(1). Therefore, no portion of the credit may be allocated to B because B is not eligible to claim any portion of the credit. A may claim the entire allowable \$7,500 credit.

Note that we don't lose half of the credit—rather we get to move the entire credit onto the return of the individual who does qualify as a first-time homebuyer.

5. Example 5 – One Owner Over the Income Limit

Given the last example, its not surprising that we would also be allowed to transfer the credit away from a taxpayer who is over the income limitation to the other partner who is not over that limit.

A contributes \$75,000 and B contributes \$25,000 towards the \$100,000 purchase price of a residence, and each owns a one-half interest in the residence as tenants in common. Under § 36(b)(1)(A), the allowable credit is not \$10,000 (10 percent of the purchase price) but is limited to \$7,500. A's MAGI is \$100,000 and B's MAGI is \$60,000. Because A's MAGI exceeds the \$95,000 MAGI cap, any portion of the credit allocated to A would be reduced to \$0. A and B may allocate the entire allowable \$7,500 credit to B because B's MAGI is less than the \$75,000 MAGI threshold and, therefore, B is eligible to claim the entire allowable credit.

6. Example 6 – One Owner in the Phase Out Range

What if one owner is not over the limit, but rather in the phase out range where they would receive only a partial credit? Again, we get lots of flexibility.

A and B each contributes \$50,000 towards the \$100,000 purchase price of a residence and owns a one-half interest in the residence as tenants in common. Under § 36(b)(1)(A), the allowable credit is not \$10,000 (10 percent of the purchase price) but is limited to \$7,500. A's MAGI is \$80,000 and B's MAGI is \$60,000. Because A's MAGI exceeds the \$75,000 MAGI threshold by \$5,000, any portion of the allowable credit allocated to A will be reduced by one-quarter, \$5,000 (MAGI in excess of \$75,000) / \$20,000. A and B may allocate the allowable \$7,500 credit one-half to A and one-half to B (\$3,750 each) based on their contributions toward the purchase price of the residence or

their ownership interests in the residence. However, A's \$3,750 portion of the credit is limited by § 36(b)(2) and is reduced by one-quarter ($\$3,750 \times .25 = \937.50) to \$2,812.50 ($\$3,750 - \937.50). Alternatively, A and B may allocate the allowable \$7,500 credit using any other reasonable method (for example, the entire credit to B because B's MAGI is less than the \$75,000 MAGI threshold and, therefore, B is eligible to claim the entire allowable credit).

Interestingly, as well, it turns out we can allocate part of the credit to A even though A ends up losing part of it. That seems to run counter to the theory that we can't allocate a credit to anyone not eligible, but it would seem that the wording means they can't take the credit rather than that we can't send it off to that black hole.

7. **Example 7 – Acquiring Property from an Unrelated Related Party**

The final example doesn't really do so much to explain joint ownership issues but rather illustrates the limit of the definition of a related party.

A and B, who are sisters, each contributes \$50,000 towards the \$100,000 purchase price of a residence and each owns a one-half interest as tenants in common. Under § 36(b)(1)(A), the allowable credit is not \$10,000 (10 percent of the purchase price) but is limited to \$7,500. A and B purchase the residence from their cousin, C. A, B, and C are not related persons within the meaning of § 36(c)(5). Therefore, A and B may allocate the allowable \$7,500 credit one-half to A and one-half to B based on their contributions toward the purchase price of the residence or their ownership interests in the residence. Alternatively, A and B may allocate the allowable \$7,500 credit using any other reasonable method (for example, the entire credit to A or B because both A and B are eligible to claim the entire allowable credit).

Obtaining the property from a cousin did not eliminate the credit, nor did the fact that both owners were sisters create a problem.

IV. **Conclusions**

This ruling gives us a lot of flexibility in allocating the credit for unmarried couples and, since the provisions continues into the first part of 2009, may be a matter we want to discuss with clients from a planning perspective.