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The Ins and Outs of the New First-Time Homebuyer Tax Credit

To stimulate home ownership amid the problems caused by the housing and mortgage meltdown, Congress has crafted another tax incentive for homeowners with the creation of the new first-time homebuyer tax credit. This tax incentive—courtesy of the recently passed Housing and Economic Recovery Act of 2008 (P.L. 110-289)—is structured as a temporary refundable tax credit, but operates more like an interest-free loan repayable over 15 years from the government for most eligible homeowners.

Just as with many other tax breaks, the first-time homebuyer credit is not a cut-and-dry tax break; there are many nuances to this incentive. For example, the credit is not designed to help homeowners who bought or owned a home in the last few years and lost it in foreclosure. The credit is intended, in part, to boost home sales and reduce the outstanding inventory of unsold homes as the result of foreclosure and to otherwise stimulate the housing market.

Credit Basics

The first-time homebuyer tax credit gives qualifying taxpayers a temporary, refundable credit equal to $7,500 ($3,750 for married individuals filing separately) or 10 percent of the purchase price of a home, whichever is less. The credit only applies to the purchase of a principal residence in the United States made after April 8, 2008 and before July 1, 2009.

The credit cannot be used for vacation or second homes. A principal residence for purposes of the credit includes a house, condominium, houseboat, mobile home or stock held by a tenant-shareholder in a cooperative housing corporation.

A "first-time homebuyer" for purposes of the credit is not necessarily someone who has never owned a home before. Rather, a "first-time homebuyer" is an individual (including an individual's spouse, if married, or other co-owner) who had no ownership interest in a principal residence during the three-year period prior to the purchase of the home to which the credit applies. The credit is not restricted to single individuals or married couples buying a home; it can be claimed by all co-owners, including same-sex couples and family members or other individuals who buy a home together.

The credit cannot be claimed if:

- the individual (or his or her spouse or other co-owner) can also claim the D.C. homebuyer credit for the tax year of the purchase or a prior tax year;
- the taxpayer used the proceeds of a tax-exempt mortgage revenue bond to finance the home purchase;
- the taxpayer is a nonresident alien; or
- the taxpayer sells or otherwise disposes of the residence, or it ceases to be his or her (and, if married, the taxpayer's spouse's) principal residence, before the end of the tax year of the purchase.

Phaseouts

The credit phases out for individuals with modified adjusted gross income

(AGI) in excess of $75,000 ($150,000 for joint filers). No credit is available when an individual's modified AGI reaches $95,000 (or $170,000 for joint filers). The phaseout reduces the credit (but not below zero) by the amount that bears the same ratio to the unreduced amount of the credit as the taxpayer's excess modified AGI over $75,000 (or $150,000 for joint filers) bears to $20,000.

> ***Example:*** Michael, a single filer, is a first-time homebuyer. His modified AGI is $80,000. He buys a home in October 2008 for $200,000. However, because Michael's modified AGI exceeds $75,000, he is subject to the phaseout. To determine the amount by which the phaseout reduces his credit, Michael takes the excess of the AGI over the threshold amount, $5,000 ($80,000 - $75,000), and divides it by $20,000. The ratio is 0.25 which, when multiplied by the maximum credit of $7,500, equals $1,875. Thus, Michael's credit is $5,625 ($7,500 less $1,875).

Modified AGI, for purposes of the phaseout, is AGI increased by any amount that has been excluded from gross income under the Code Sec. 911 exclusion for foreign earned income and housing costs, the Code Sec. 931 exclusion for income derived from sources in certain U.S. possessions (including Guam, American Samoa and the Northern Mariana Islands) and the Code Sec. 933 exclusion for income from Puerto Rico.

Claiming the Credit

The credit is only available for home purchases (title closings) made after April 8, 2008 and before July 1, 2009. This means that eligible homeowners who close in 2008 must wait to receive the credit until they file their 2008 returns. Those who buy a home during the eligible period in 2009, however, can elect to treat the purchase as having been made on Dec. 31, 2008, and therefore can amend their 2008 return to claim the credit.

The option to amend a 2008 income tax return for purposes of claiming the credit will also accelerate the start of the repayment period. To account both for the benefit of the credit before a return is filed and for the additional tax burden in paying back the credit over the 15-year period, homebuyers may need to make adjustments to their future withholding or estimated tax payments.

> ***Comment:*** The election to claim the credit in 2008 for a home purchased in the applicable 2009 period is an option that comes closest to making the credit funds available as close to the closing date as possible. It is likely, however, that a funding technique will develop to effectively advance these funds to homebuyers at closing, with terms likely to call for interest and a security interest in the taxpayer's refundable credit when he or she receives the amount.

Related-Party Purchases

A "purchase" for purposes of the credit is nearly any acquisition by the taxpayer. However, if the home is acquired from a person who is related to the buyer there are a few twists that affect how the property's basis is determined.

First, the taxpayer's basis in the property cannot be determined, in any way, by reference to the transferor's adjusted basis. Second, if the transferor was a decedent, the taxpayer's basis in the property cannot be stepped up to the fair market value (or special use value) on the date of death or alternate valuation date, if applicable.

Repayment

The credit must generally be recaptured (repaid), interest-free, ratably over a 15-year period. Repayment starts two years after the date of the home's purchase. The recapture works by increasing the taxpayer's federal income tax liability by 6 2/3 percent of the credit amount (equal to 1/15th of the credit amount) for each year during the 15-year recapture period beginning with the second tax year following the tax year in which the home was purchased. Further, half of any credit amount that is allowed on a joint return is treated as having been allowed to each spouse.

> ***Example:*** Kate is single and a first-time homebuyer who purchases a

condo in August 2008 for $75,000. Her modified AGI is $70,000. The condo is her principal residence. Kate is eligible to claim a $7,500 credit, the maximum amount, on her 2008 return. Beginning with her 2010 return, Kate must recapture the credit by increasing her federal income tax liability by $500 each year ($7,500 x 6 2/3 percent) for the next 15 years.

If the taxpayer sells or no longer uses the home as a principal residence before fully repaying the credit, the remaining unpaid amount of the credit is accelerated and becomes due on the individual's return for the year in which the residence is sold or is no longer used as a principal residence. However, the accelerated recapture amount cannot exceed the amount of gain (if any) from the sale of the residence to an unrelated person. For this purpose, gain is determined by reducing the basis of the residence by the amount of the credit that was not recaptured before the home was sold (or no longer used as the principal residence).

Comment: The provision that prevents an accelerated recapture amount from exceeding any gain on the sale of the home causes the credit to operate as a limited insurance policy against loss on a future sale of the home. In effect, the government will absorb loss on the sale up to the remaining amount of the taxpayer's credit.

Other Exceptions

There are other exceptions to the recapture acceleration rules. Any outstanding credit amount is not required to be recaptured if any of the following occur:

If the taxpayer dies there is no recapture at all.

There is no accelerated recapture as long as the taxpayer acquires a new principal residence within two years of the date the taxpayer disposes of the home or ceases to use it as a principal residence.

There is no acceleration of recapture if there is a transfer of the residence to a spouse, or to a former spouse incident to a divorce. For tax years ending after the transfer, the transferee steps into the shoes of the transferor for purposes of both the regular and accelerated recapture rules. The transferor is no longer responsible for any recapture.

Comment: For any year in which recapture of the credit increases a taxpayer's income tax, he or she must file an income tax return, even if he or she is not otherwise required to file a return because the individual does not meet the gross income filing threshold.

State Tax Implications

In general, states do not incorporate federal tax credits. However, any first-time homebuyer tax credit cannot be claimed by a taxpayer who claims, or is eligible to claim, the D.C. first-time homebuyer tax credit. Additionally, under certain recapture provisions, such as acceleration of the recapture where the home is sold, the basis of the home may have to be reduced, which may create a different basis in the property, and thus a different gain or loss upon sale for federal and state income tax purposes. Therefore, the effect of the first-time homebuyer tax credit for state income tax purposes should be examined. ■

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