New Real Estate Tax Deduction

Is it a Loan, Tax Credit or Hybrid?

By Robert Clovey

In its continuing efforts to stimulate the U.S. economy, Congress passed the Housing Assistance Tax Act (HATA) on June 30, 2008. One of the main provisions of HATA provides assistance to prospective or first-time homeowners and current homeowners paying state and local real estate taxes and who do not file Schedule A.

In the case of prospective homeowners, they may be eligible for a first-time homebuyers' refundable credit/interest-free loan. The credit is restricted to taxpayers purchasing a primary residence, as defined by IRC section 121. Current homeowners can receive an additional standard deduction that is taken on line 39(c) of the revised Form 1040. The deduction allows taxpayers a deduction for real property taxes paid (subject to limitations) even if the taxpayer does not itemize.

This article explains the new loan/refundable credit and its effect on first-time homebuyers. It also notes the check-off for the new additional standard deduction on Form 1040 and concludes by identifying taxpayers who are affected and should have a working knowledge of the provisions.

Loan/Refundable Credit

HATA provides first-time home buyers with a deduction whose substance is a 15-year interest-free loan but whose form is a refundable tax credit. First-time home buyers are defined as individuals who did not have an interest in a principal residence during the three-year period ending on the date of purchase. Taxpayers having an interest in rental property or vacation homes will qualify for this credit. This credit is unique in that it must be repaid. In the past, all credits were either refundable or nonrefundable.

Eligible taxpayers are allowed a maximum credit of the smaller of $7,500 or 10% of the purchase price. Married taxpayers filing separate returns are entitled to a maximum credit of $3,750 each. The credit is phased out for unmarried taxpayers with modified adjusted gross income (MAGI) between $75,000 and $95,000 ($150,000 and $170,000 for married taxpayers filing jointly). To be eligible, individuals must purchase a primary residence after April 9, 2008, but before July 1, 2009. The credit should be claimed in the year of purchase, but taxpayers purchasing property after December 31, 2008, and before July 1, 2009, can elect to treat the purchase as occurring in 2008. If the 2008 tax return was not yet filed, the credit can be claimed on the 2008 return, or the 2008 return can be amended to claim the credit.

In general, taxpayers utilizing the credit must repay it evenly over a 15-year period, meaning 1/15 (6 2/3%) of the credit deducted per year. The repayment will be in the form of an increase in the taxpayers' future tax liability or a reduction in their tax refund. Repayment must begin two years after the year in which it was claimed. The loan is accelerated if the taxpayer sells the residence to an unrelated person before the credit is fully recaptured. The credit is not recaptured in the case of death, involuntary conversion, or transfers between spouses or as a result of divorce.

Example. Sam, a single individual and a first-time home buyer, purchases a home for $285,000 and uses it as his principal residence. Sam's MAGI is $62,500, therefore he qualifies for the $7,500 credit. If the residence is purchased on January 5, 2009, Sam can elect to treat the purchase as occurring on December 31, 2008, and claim the credit on his 2008 tax return. Repayment of the credit must begin two years after the credit is claimed—the 2010 tax return. His repayment will be $500 (1/15 of $7,500) per year for 15 years.

This unusual credit can be utilized by Sam in a variety of ways. It can be an interest-free loan that may be accelerated, it can be a credit in the traditional sense of a credit, or it can be part credit and part interest-free loan:

- If he disposes the home at a loss within two years after purchase, then no payments will have been made.
- If he disposes the home at a small gain within two years of purchase, then no payments will have been made and the realized gain will not be sufficient to cover the credit taken—making it akin to an accelerated loan.
- If he disposes the home at a large gain within two years of purchase, then no payments will have been made—making it akin to an accelerated loan.
- If he disposes the home at a loss later than two years after purchase, then some payments will have already been made but the rest will be forgiven, making it akin to part credit and part interest-free loan.
- If he disposes the home at a gain two years or later after purchase, then the credit would be akin to an interest-free loan.

Assume that Sam disposed of the residence after five years and repaid $1,500 of the $7,500 credit. If he had a loss on disposal of $15,000, then the balance ($6,000) of the loan is forgiven and can be viewed retroactively as a credit of $6,000 and a loan of $1,500.

Certain taxpayers are not eligible for the credit:

- Individuals whose MAGI exceeds the upper limit.
- Non-resident alien purchasers.
- Purchasers who took advantage of the first-time homebuyer credit in the District of Columbia.
- Individuals who received the property as a gift or inheritance.
- Individuals who purchased the property from a spouse, ancestor, or lineal descendents.
- Taxpayers who cease to use the property as primary residence.
- Taxpayers who dispose of property within one year of purchase.
- Taxpayers whose mortgage proceeds are from tax-exempt mortgage bonds.

Additional Standard Deduction

The standard deduction consists of the basic standard deduction and the additional standard deduction. To be eligible for an additional standard deduction, taxpayers had to have been at least 65 years old or blind; to qualify for two additional standard deductions, taxpayers had to meet both conditions. HATA provides a new additional standard deduction for state and local property taxes paid. In the past, taxes were generally deductible only for taxpayers who itemized deductions. In essence, a taxpayer who did not itemize was not entitled to a deduction for real estate taxes paid. For 2008, however, taxpayers who do not itemize can claim an additional standard deduction for property taxes paid.

Under this new provision, taxpayers are allowed a deduction for the lesser of $500 or the amount of real property taxes that were paid during the year ($1,000 for married couples filing jointly). This will increase the 2008 standard deduction taken on line 40 from $5,450 to $5,950 for single taxpayers and from $10,900 to $11,900 for married couples. For taxpayers claiming head of household, the exemption goes from $8,000 to $8,500. As in the past, taxpayers who are 65 years old or older or blind will add their additional standard deductions to the amounts computed above.

On the IRS advance draft copy of the 1040 dated September 1, 2008, the check-off for the additional standard deductions for taxpayers over 65 or blind are located on line 39(a). Line 39(b) pertains to spouses who itemize on separate returns. The additional standard deduction for state and local property taxes for non-itemizers is placed on line 39(c).

Opportunities for Taxpayers

Individuals purchasing a home or owners of a home who do not file Schedule A should have a working knowledge of these changes or be alerted by their tax preparer. These changes will impact the taxable income of individuals who buy or build a home in 2008 and 2009. Additionally, the changes can affect homeowners with no mortgage as well as individuals with a mortgage who cannot file Schedule A. ❑

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