TAX LAW to the RESCUE

Those big bailouts don't really help homeowners, but there's relief to be had from (gasp!) the IRS

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CONCERNS ABOUT THE STATE OF the U.S. economy can be illustrated in many ways: financial charts depicting the wild swings of the stock market, gloomy data coming out of the housing market, and even the personal testimony of homeowners who lost their properties to foreclosure and workers who lost their jobs.

But perhaps the most telling measure of the economic crisis has been the escalating involvement of the federal government in efforts to prop up various segments of the nation's financial structure.

The government took its most dramatic steps as summer turned to fall. In early September, it took over Fannie Mae and Freddie Mac, which between them hold or guarantee roughly half the nation's private housing debt. Barely a week later, the government agreed to bail out insurance giant American International Group, even while it refused to help save at least one major investment banking house from bankruptcy. Then the Federal Reserve poured nearly $300 billion into global credit markets as the Bush administration and congressional leaders began discussing a plan to buy up distressed mortgages to ease the strain on financial institutions.

Eventually, these salvage efforts are supposed to bring stability back to nervous financial markets that will help make it easier for individuals and families to keep up with mortgages and get new credit to make consumer purchases that fuel the economy. But the government's latest rescue efforts have not included provisions aimed specifically at individual consumers.

It's been another story, though, with some earlier tax bills passed by Congress and signed by President Bush. Tax legislation implemented over the past year or so contains a number of provisions aimed at helping taxpayers caught up in the economic maelstrom that was initially triggered by the meltdown in the subprime mortgage market.

Last December, Congress enacted the Mortgage Forgiveness Debt Relief Act of 2007. The act seeks to alleviate the effect of treating a foreclosure under the Internal Revenue Code as a real estate sale or disposition that results in a realized gain or loss.

The general rule is that, if there is a gain on the sale of a primary personal residence of

less than $500,000 for a husband and wife filing jointly, it will be excluded from gross income, while any loss is disallowed as a deduction. (For those who qualify for a different filing status, the exclusion amount generally is $250,000.)

Mortgage debt forgiveness, however, is normally includable in gross income. That can create situations in which a taxpayer who lost a house through foreclosure might still have to pay income taxes even though there was no actual increase in the taxpayer's wealth.

The act changes the rule on debt forgiveness for the 2007, 2008 and 2009 tax years by excluding from gross income up to $2 million of such debt cancellation income for a foreclosure that occurs between Jan. 1, 2007, and Dec. 31, 2009.

In February, Bush signed the Economic Stimulus Act of 2008, which provided for a one-time refundable credit against personal income taxes of $600 per individual (and another $300 for qualified dependents). As of the end of August, this governmental effort to pump some fresh money into the economy resulted in more than $93 billion in payments to nearly 115 million taxpayers.

Although the tax credit payments received most of the publicity, the Economic Stimulus Act also included a provision aimed at recharging the housing sector by raising the maximum loan amounts homebuyers may receive for mortgages backed by the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corp. (Freddie Mac), along with those issued through the Federal Housing Administration and other federal agencies.

Then in May, the Food, Conservation and Energy Act of 2008 became law. Included in the tax title of the act was assistance to help military veterans purchase homes by authorizing several states to issue qualified veterans mortgage bonds under which interest payments are tax-exempt.

And finally in July, Congress passed the Housing and Economic Recovery Act of 2008 in a further attempt to address the continuing slump in housing sales and related concerns. While the act is far-reaching, the tax provisions—contained in the Housing Assistance Tax Act of 2008—make significant changes in the federal tax rules applicable to the U.S. real estate market, and especially to individual homeowners.

A BREAK FOR FIRST-TIME HOMEBUYERS

PERHAPS THE MOST INNOVATIVE PROVISION IN THE HOUSing Assistance Tax Act is a new repayable credit for principal-residence purchases by first-time homebuyers.

Unlike most tax credits, however, this one must be repaid to the federal government in equal installments over 15 years, without interest. So in effect, this credit amounts to an interest-free loan from the government to qualifying first-time homebuyers. (A first-time homebuyer is defined by the act as someone who had no ownership interest in a principal residence in the United States during the three-year period ending on the date of the purchase.)

The credit is equal to 10 percent of the purchase price of the residence, up to a maximum of $7,500 for a single person or a married couple filing jointly (but $3,750 for a married person filing separately). The credit phases out for individuals with a modified adjusted gross income between $75,000 and $95,000, and for joint filers with income between $150,000 and $170,000.

The credit applies to residences bought between April 9, 2008, and July 31, 2009. Generally, the credit is allowable for the year in which the purchase is made, but taxpayers buying residences between January and July 2009 may treat their purchases as having taken place on Dec. 31, 2008, and claim the credit on their 2008 tax returns.

Repayment generally must start in the second tax year after the home is purchased as an addition to the amount of taxes due. A taxpayer who elects to treat a 2009 purchase as a 2008 purchase will begin repayment in 2010—the second tax year after 2008. If the taxpayer sells the home or ceases to use it as a principal residence before the credit has been completely repaid, the remaining unpaid credit is due on the tax return for the year in which the home is sold or ceases to be used as a principal residence.

If the owner sells the residence to an unrelated buyer, the repayment amount may not exceed the amount of gain from the sale. For this purpose, gain is determined by reducing the basis (essentially, the owner's original purchase price subject to adjustments) by the amount of the credit not previously recaptured.

As an example, assume that Hazel Smith purchases a new house for $250,000 on Dec. 31, 2008, and claims a $7,500 credit on her 2008 return. She repays $500 of that credit in 2010 and another $500 in 2011. During that time, she makes no improvements and has no other basis adjustments to her house. On June 30, 2012, she sells her house to an unrelated buyer for $245,000. For purposes of determining Smith's repayment amount, her basis is deemed to be $243,500 ($250,000 minus the $6,500 unrecaptured credit). Accordingly, Smith's repayment amount is limited to $1,500.

If a residence is involuntarily converted (defined as a loss resulting from destruction, theft, seizure or condemnation), repayment of the credit will not be accelerated if a new principal residence is acquired within two years. If the residence is transferred to a spouse or former spouse incident to divorce, that spouse will be responsible for repayment of the credit from that point on. The credit does not have to be repaid if the taxpayer dies.

The credit is not available to nonresident aliens, even for a principal residence in the U.S., or to buyers whose financing is from tax-exempt revenue bonds. The credit also will be disallowed for a buyer who disposes of the home or ceases to use it as a principal residence before the end of the year for which the credit would have been allowable. If a previously adopted tax credit for first-time homebuyers in the District of Columbia is renewed, they will not be able to claim both that credit

and the credit under the Housing Assistance Tax Act.

In another change affecting many first-time homebuyers, the 2008 tax act is making a key change in rules for mortgage revenue bonds.

Those bonds are sold by state and local government housing-finance agencies to finance below-market mortgages for qualifying first-time homebuyers. But many of these subprime borrowers are facing interest rate resets on their existing loans, which has helped trigger the crisis in the housing market that spawned the concerns about the economy as a whole. The 2008 act authorizes refinancing of existing subprime loans financed by mortgage revenue bonds to help borrowers refinance into new loans with more favorable rates.

BOOSTING THE STANDARD

FOR THE 2008 TAX YEAR ONLY, taxpayers who do not itemize deductions may increase their standard deduction to account for real estate property taxes assessed by state or local governments. For those taxpayers, the addition to the standard deduction may be the amount of their state and local property taxes or $500 ($1,000 for joint filers), whichever is less.

For owners of cooperative apartments, the additional deduction would be based on their pro rata share of the cooperative corporation's real property taxes.

This addition to the standard deduction is intended to help low-income homeowners and taxpayers who don't itemize interest payments because they have paid off mortgages. In both cases, itemized deductions generally don't exceed the standard deduction.

MORE HELP FOR HURRICANE VICTIMS

SHORTLY AFTER HURRICANE KATRINA STRUCK THE GULF Coast in 2005, Congress enacted the Katrina Emergency Tax Relief Act. Later that year, after the region was hit by hurricanes Rita and Wilma, Congress passed the Gulf Opportunity Zone Act. This year's Housing Assistance Tax Act—enacted before hurricanes Gustav and Ike battered the coast in September—added $1.8 billion to funding for incentive programs created by GOZA.

Of particular significance is a provision in the 2008 act that expands casualty loss relief for owners of homes that were damaged by the hurricanes in 2005.

Under the Internal Revenue Code, nonbusiness casualty losses generally may be taken as itemized deductions to the extent they exceed 10 percent of adjusted gross income, subject to a $100 floor. GOZA eliminated both restrictions for homeowners in the region affected by the hurricanes, thereby allowing more taxpayers to claim a casualty loss deduction for 2005.

The value of casualty losses to homeowners depends, however, on their tax bracket, so low-income taxpayers generally received little benefit when GOZA changed the rules for deducting casualty losses.

In addition, many taxpayers who claimed casualty loss deductions later received rebuilding grants under programs such as Louisiana's Road Home, which they had to claim as income on their subsequent federal tax returns. And because the rebuilding grants often moved homeowners into a higher tax bracket, they ended up paying taxes that were more than any reductions they got on their 2005 returns when they deducted casualty losses.

The 2008 act remedies this inequity by allowing taxpayers who claimed a 2005 casualty deduction for damages from Katrina, Rita or Wilma to amend their 2005 returns. This will allow them to eliminate the casualty loss deduction to the extent of any rebuilding grants they received. These taxpayers must repay their tax savings plus one year of interest; in return, they may exclude the rebuilding grants from income.

Here's an example: Ebenezer Taxpayer, who lives in the region hit by Katrina, Rita and Wilma, had relatively low income in 2005. Taxpayer claims a $10,000 deduction for casualty losses. In his 10 percent tax bracket, that means a reduction of $1,000. But if he pays back that $1,000 (plus any applicable interest), Taxpayer may exclude a $10,000 rebuilding grant that would have been taxable to him at 33 percent, thereby costing him $3,300 in taxes. So he saves the difference between $3,300 and $1,060, or $2,240.

A BREAK FOR MILITARY PERSONNEL

THE SERVICEMEMBERS CIVIL RELIEF ACT OF 2003 IMPLEmented major revisions in protections for members of the U.S. military facing proceedings in civil courts while on active duty. Among those enhanced protections were measures to prevent cases of mortgage foreclosure involving military personnel.

The 2008 tax act reinforces those protections on a temporary basis while imposing caps on mortgage interest rates for service members. Under the act, for instance, a service member may request that a mortgage lender keep the interest rate at no more than 6 percent while he or she is on active duty, and the lender must recalculate monthly payments accordingly.

SOME RELIEF FROM THE AMT

BEFORE THE HOUSING ASSISTANCE TAX ACT WAS PASSED, interest on tax-exempt bonds issued to help finance private housing projects was a preference item for the alternative minimum tax. (A tax preference is a special adjustment made to certain items in determining alternative minimum taxable income. As a result of tax preference items, a taxpayer may have to pay an alternative minimum tax in addition to the regular tax on his taxable income.) As a result, taxpayers subject to the AMT were in effect taxed on these "tax-exempt" bonds, which made them less attractive and forced developers to issue bonds at a higher interest rate.

The act provides that interest on certain tax-exempt bonds issued after July 30, 2008, will no longer be considered preference items.

Taken off the list of preference items are exempt facility bonds that are part of a larger issue from which at

least 95 percent of the net proceeds are used to provide qualified residential rental projects, qualified mortgage bonds and qualified veterans' mortgage bonds.

The act also includes reforms for real estate investment trusts. A REIT is a trust or corporation that holds passive investments in real property and mortgages, and that elects to be taxed under special—and complex—rules. Many of the new REIT provisions were proposed before the current crisis in the real estate market, but as the crisis worsened, many experts argued that the new rules were even more necessary to support REITs as a viable real estate investment mechanism.

SIMPLIFYING LOW-INCOME HOUSING TAX CREDITS

AS ENACTED IN 1986, THE LOW-INCOME HOUSING TAX credit is available over a 10-year period to owners of real estate development projects providing low-income housing for at least 15 years. The credit is based on the cost of the project and on the percentage of low-income units.

The 2008 tax act temporarily liberalizes the credit to encourage development of low-income housing.

Only a certain number of credits may be issued for projects around the country. To be eligible for the credit, a developer or property owner must obtain a credit allocation from a state or local government agency. The act has increased the number of credits available in each state for 2008 and 2009, and the amount of each credit has been raised. Under the new formula, each state's total credits will be an amount equal to the state's total number of residents multiplied by $2.20 per resident (up from $2 per resident), with fixed minimums for certain smaller states.

The act also seeks to simplify the process of calculating the credit, which is determined under a complex formula that applies an "applicable percentage" to the taxpayer's "qualified basis" in the property. In addition, low-income housing credits for buildings placed in service after Dec. 31, 2007, as well as a separate rehabilitation tax credit, may offset the alternative minimum tax.

WHO FOOTS THE BILL?

THE HATA IS PROJECTED TO PRODUCE A LITTLE MORE than $15 billion in tax relief for various real estate owners and developers over the next decade. But those tax breaks have to be offset by revenue from other sources.

One new source of tax revenue is a provision affecting taxpayers with vacation homes or rental properties that later become their principal residences.

Prior to passage of the tax act, so long as the taxpayer owned the residence and used it as a principal residence for two of the five years that end with the sale or exchange of the property, the taxpayer was permitted to exclude up to $250,000 ($500,000 for joint filers) of gain realized on the sale or exchange of the residence (not including gain arising from prior depreciation).

But under the act, any gain from the sale or exchange of the residence allocated to periods of "nonqualified use" must be declared as income. The nonqualified-use period is defined as any time after Jan. 1, 2009, during which the property is not used by the taxpayer or the taxpayer's spouse or former spouse as a principal residence. The act makes exception for temporary absences of up to two years by reason of a change in employment, health or even certain circumstances defined as "unforeseen." Exceptions also are recognized for members of the uniformed services, the foreign service and the intelligence community on extended duty.

For example: A taxpayer purchases a house on Jan. 1, 2009, for $300,000 and uses it as a vacation home until Jan. 1, 2010. On that date, the taxpayer makes it his principal residence. On Jan. 1, 2013, he sells the house for $500,000, thus realizing a $200,000 capital gain. Since there was a one-year nonqualified use out of four years of ownership, 25 percent of the gain, or $50,000, is not eligible for exclusion from income. The taxpayer may exclude gain of $150,000. If the taxpayer had vacated the house on Jan. 1, 2013, but did not sell it until Jan. 1, 2014, there would be one year of nonqualified use during five years of ownership, so only 20 percent of the gain, or $40,000, would have to be included as taxable income.

Other provisions will have a less direct effect on individual taxpayers, but their impact is still likely to be felt.

The largest projected source of tax revenue under the 2008 act is a reporting requirement for banks and other financial institutions that process credit card transactions for merchants. Under the new rule, a bank must report a merchant's annual gross payment-card receipts both to the IRS and the merchant. Previously, that information was not available to the IRS except on a case-by-case basis, so the new law is expected to substantially increase compliance among merchants for reporting income from credit card transactions. The requirement will become effective for sales made on or after Jan. 1, 2011.

Similar rules will be applied to various third-party network transactions used by online businesses. There is a de minimis exception if the aggregate value of third-party network transactions does not exceed $20,000 for a calendar year or the number of transactions for the year does not exceed 200.

One welcome provision in the Housing Assistance Tax Act has more to do with paperwork than taxes. The Foreign Investment in Real Property Tax Act of 1980 requires sellers to execute an affidavit stating that they are not nonresident aliens who would be subject to withholding. The affidavit must include the seller's taxpayer identification number, which in most cases is a Social Security number. In an effort to help prevent identity theft, the 2008 act permits sellers to give the affidavit only to the title or escrow company processing the closing.

If only all the problems coming out of the real estate market these days could be solved so easily. ■

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