TAX POLICY ENCOURAGES HOME OWNERSHIP

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Abstract

This paper examines the tax code provisions that encourage home ownership, including a discussion of some new legislation that also falls within the current administration's economic stimulus package. It reviews tax provisions dealing with buying a home, owning a home, and selling a home, as well as tax credits and special treatment of some expenses.

Ben Franklin is credited with saying that "Beer is proof that god loves us and wants us to be happy." If we may paraphrase Mr. Franklin, the IRS treatment of home owners is proof that Uncle Sam loves home owners and wants them to be happy.

Home ownership has long been a part of the "American Dream," and for many acquiring that first home was indeed a dream come true. However, the current state of the economy, with the meltdown on Wall Street, the federal bail-out programs, and the sub-prime mortgage debacle, acquiring or owning a home has

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become a nightmare for many contemporary home buyers and owners. The National Association of Home Buyers believes the American housing industry is now facing the worst crisis since the Great Depression. Given the importance of the building industry to the economy, and the correlation between the housing market, new home construction starts, and consumer confidence, the restoration of this part of the "American Dream" is extremely important. Evidence of how important the building industry is to the national economy can be found in the historic and the contemporary tax treatment and benefits associated with home ownership and home acquisition.

Tax law has long helped support the "American Dream" of home ownership by allowing the home owner to take deductions for mortgage interest and real estate taxes, thereby providing tax deductions – some would even say relief – that was not available to renters. During the current economic crisis there have been additional laws enacted that provide even greater tax benefits to new home buyers, using tax policies to promote home ownership, new housing starts, and to "kick-start" the housing industry. There have also been provisions that give tax benefits for all home owners, whether new or existing, in the area of energy conservation. This paper will give an overview of the many income tax provisions and protections dealing with home acquisition, ownership, and disposal, with particular emphasis on new tax legislation.

TAX BENEFITS FROM BUYING OR OWNING A HOME

Some of the expenses associated with home ownership are "income tax friendly" expenses. For example, both real estate taxes and mortgage interest have long been allowed as itemized deductions on Schedule A of the long form 1040 individual income tax return, as most taxpayers know. However, many people do not realize that there are special provisions in the Internal Revenue Code for *buying* a home, for *owning* a home, and even for *selling* a home. A discussion of these special provisions by category is set out below.

Points

Anyone who has ever applied for a mortgage has dealt with "points," certain fees to be paid in order to acquire a mortgage. Each "point" is one percent of the total amount of the loan. However, while the term itself is simple, its application to any given mortgage can be quite confusing. The buyer may be dealing with *origination* points, which involve the cost of the obtaining the loan. These points generally are not deductible if they are paid to cover closing costs. They are just a cost of "doing business." If they are used to obtain the loan, they generally are tax deductible, but they must be amortized over the life of the loan.[4] Similarly, points paid to refinance a loan must be amortized over the life of the "new" loan. The tax benefits to be derived, if any, are generally minimal, and the borrower would be better served seeking a loan without origination points from both an immediate and a tax perspective.[5]

Discount points, on the other hand, are deductible.[6] Discount points are actually pre-paid interest, with the borrower paying "points" (one percent of the loan amount) to buy a discounted interest rate on the mortgage. The amount of the discount will vary with the lender, but will commonly be for some fraction of a percentage point of interest over the life of the mortgage. For example, the lender may offer the borrower a mortgage with an original rate of 7.5%, but then offer to discount the percent .25% per point. If the borrower pays two points, he or she will be purchasing a discount of .5%, lowering the mortgage rate to 7.0%. These discount points are tax deductible in the year in which they are paid.

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[4] I.R.C. § 461(g)(1).
[5] "What Are Mortgage Points," Mortgage News Daily, found at http://www.mortgagenewsdaily.com/wiki/Mortgage_Points.asp.
[6] Rev. Proc. 94-27, 1994 – 1 CB 613.

A home buyer should carefully consider the potential tax benefits and the budget consequences of purchasing such points. Bankrate.com suggests that the purchaser should not purchase discount points unless he or she is paying at least 20% down, since the lender is likely to require the purchaser to get purchase mortgage insurance (PMI) as part to the loan. According to this source, the purchaser would be better served to pay more money down than to purchase a lower rate on a higher loan amount.[7]

Assume that a buyer is borrowing $100,000 to finance the purchase of a new home, with a 30 year mortgage at 5.0%. The mortgage will have a monthly payment of $536.82, with total payments to pay off the loan of $193,255.78, of which $93,255.78 is interest. By purchasing two points the loan amount and the time remain unchanged, but the interest declines to 4.5%. Monthly payments would now be $506.69; total payments would amount to $182,406.71, a savings of nearly $11,000 over the life of the loan. The purchaser would recover the cost of the points in 66 months.[8]

Remember that these discount points are assessed in order for a home buyer to lock in a low interest rate. The lender does not think this rate will continue as the market rate throughout the loan term, expecting that the market rate would rise in the future. In addition, you can also deduct points paid on a loan to improve your home.

Housing and Assistance Tax Act of 2008 – Homebuyer Credit

The Housing and Assistance Tax Act of 2008,[9] signed into law by President Bush on July 30, 2008, was a wide-ranging law intended to address the subprime mortgage crisis. One part of this law was the *Housing Assistance Tax Act of 2008*, which provided three rather significant changes in the tax law for homeowners. The

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[7] Bankrate.com, found at
http://www.bankrate.com/calculators/mortgages/mortgage-point-adviser-4.aspx

[8] "Mortgage Points Calculator," Money-zine.com, found at http://www.money-zine.com/Calculators/Mortgage-Calculators/Mortgage-Points-Calculator/.

[9] H.R. 3221.

first of these, the *First Time Homebuyer Tax Credit*, is for first time home owners. A tax credit of up to $7,500 was authorized for "first time" homebuyers, with the credit to be repaid over 15 years – in, effect an interest-free "loan" to first time homebuyers. Any qualified purchase of a home between April 9, 2008 and June 30, 2009 was eligible, including the construction of a new home. This "credit" must be repaid to the government ratably over a 15 year period beginning in the second year following the year of purchase at a rate of 1/15 per year. This would amount to an additional tax of $500 per year if the maximum credit was claimed.

Interestingly, a "first time homebuyer" did not have to be purchasing a home for the first time. As the term was defined, anyone who has not owned a home in the three years prior to the purchase of the home to which the credit would apply was treated as a "first time homebuyer" and thus potentially eligible for this credit.

The full credit is limited to the lesser of (a) $7,500 ($3,750 for a married taxpayer filing a separate return) or (b) 10 percent of the purchase price of the home, and is only available to U.S. citizens or resident aliens. Only those taxpayers who have a modified AGI of less than $75,000 (single) or $150,000 (married filing jointly) can claim the full credit. For any taxpayer with an AGI of more than $75,000 (single) or $150,000 (married); the tax credit is gradually phased out for taxpayers whose AGI exceeds these amounts, and is not available for taxpayers with an AGI of $95,000 ($170,000 for married taxpayers filing jointly).[10] The phase out "range" is $20,000, and the amount of the credit is reduced by the percentage of the $20,000 the taxpayer earns above the targeted income amount. For example, a couple with an AGI of $160,000 is $10,000 above the targeted income, so they would only get 50% of the credit. This AGI restriction only applies in the year

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[10] Kaye A. Thomas, "Guide to the First-Time Homebuyer Credit," Tax Guide for Investors (February 27, 2009). Found at http://www.fairmark.com/housing/homebuyer-credit.htm

of the purchase. The credit taken by a taxpayer whose AGI exceeds the targeted amount in future years is not affected.

If a taxpayer either sells the home or it ceases to be the principal residence before the end of the credit repayment period, the entire amount of the credit not yet "recaptured" must be repaid in the year in which the sale or use change occurs. Even then there is a protection for the homeowner since the amount of the recapture cannot exceed the gain on the sale of the residence measured by computing the gain in the normal fashion and reducing it by the amount of the unrecaptured credit. There are several exceptions to the recapture rules:

- If there is no gain (as computed above) on the sale, the remaining unrecaptured credit is forgiven.
- No recapture if the taxpayer dies.
- No recapture upon an involuntary conversion as long as a new residence is acquired within two years. The recapture amount will carry over to the new residence.
- Transfer of a residence incident to divorce does not trigger recapture. The new owner is liable for the recapture.

Additional Standard Deduction for Property Taxes

The second significant change found in the Housing Assistance Tax Act of 2008[11] is the *Additional Standard Deduction Provision*, a new provision that allows an "additional" standard deduction for property taxes, allowing a taxpayer who does not itemize deductions to claim an addition to the standard deduction for real estate taxes paid. This additional standard deduction increases the "normal" standard deduction amount by the lesser of

[11] H.R. 3221, Public Law 110-289.

(1) the allowable deduction for state and local real estate taxes or $1,000 ($500 if single).[12] This provision will allow taxpayers who do not have enough deductions to itemize to at least be able to deduct some of the real estate taxes paid. This provision should be very appealing to taxpayers who own property but do not itemize their deductions, especially retired couples who can no longer itemize. This provision is currently effective for the 2008 and 2009 tax years. It has not been extended to 2010.

The third new provision benefiting homeowners under the Housing Assistance Tax Act of 2008 is the *Prorated Capital Gain Exclusion*, which deals with § 121 of the Internal Revenue Code and the recognition of capital gain from the sale of the taxpayer's principal residence. This provision is discussed in detail later in this paper.

2009 and 2010 $8000 Maximum Tax Credit-First Time Home Buyers

The American Recovery and Reinvestment Act (ARRA) of 2009 provides a tax credit of up to $8,000 for first time buyers of a personal residence. In order to qualify for this tax credit the residence must be purchased on or after January 1, 2009 by a "first time home buyer." This credit is a variation on the First Time Homebuyer's Credit from 2008, a variation that is even more beneficial for covered homebuyers. Once again, the name of the credit is a bit misleading since the statute still defines a "first time home buyer" as a buyer who has not *owned* a principal residence during the three year period prior to the purchase. If a couple is trying to use this tax credit, the rule applies to both the husband and the wife. The credit is now 10% of the home purchase price up to a maximum credit of $8,000 (an increase of $500 from 2008), but the biggest change is that this credit does not have to be repaid. (Recall that the 2008 credit had to be repaid over the next fifteen years, making it, in effect, more of a loan than a credit.)

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[12] I.R.C. § 62(c)(1)(C).

Under this new provision the taxpayer gets all of the benefit of the credit without the subsequent burden of repaying the "credit."

This credit has recently been extended through April 30, 2010, although the "first time" purchase does not have to be completed until June 30, 2010. If a buyer had entered into a contract to purchase before May 1, 2010 and the purchase is completed before July 1, 2010, he or she can still take the credit. (At this time no further extensions of this credit are contemplated, but such extensions are still a possibility.) For qualified military service members, the deadline has been extended until April 30, 2011. For purchases made between January 1 and October 31, 2009, the credit was a maximum of $8000, based on 10% of the purchase price. For any purchases made after November 1, 2009, the credit is only available for houses with a purchase price no greater than $800,000. For any houses with a purchase price above $800,000 no tax credit is allowed, with no provision for a phase out or reduction of the credit. The credit is phased out for buyers with modified adjusted gross income (AGI) of more than $75,000 for a single taxpayer and $150,000 for married taxpayers filing a joint return.

Assume a single individual has modified AGI of $86,000. Thus AGI exceeds the base of $75,000 by $11,000. This excess over the base is then divided by $20,000, the "phase out" amount. The $11,000 excess is 55% of $20,000, so the taxpayer "loses" 55% of the credit; he or she is only allowed to take 45% of the credit.

To qualify for this credit the home must be used as the principal residence of the taxpayer. The credit is "refundable" in that the credit can be claimed and will be refunded to the taxpayer even if the taxpayer has no tax liability against which to offset the credit. The credit is claimed by filing Form 5405 with the individual tax return. No preapproval is necessary. However, the taxpayer must repay the credit if the home ceases to be his or her primary residence during the three years beginning on the purchase date. This provision significantly altered the initial 2008 first time homebuyer tax credit, discussed above. This provision is waived if the move is due to government ordered extended military duty service.

Long-term Residents - $6,500 Tax Credit

A new $6,500 credit is available for "long-term" residents who decide to purchase a new home, provided that they make their purchases after November 6, 2009 and before April 30, 2010. Taxpayers who have a contract for the purchase before May 1, 2010 are also eligible for the credit if they close on the purchase no later than July 1, 2010. Taxpayers must have lived in a residence for at least five consecutive years in the past eight years. If they meet this test, they qualify for a new credit of 10% of purchase price of the new home, with a maximum of $6,500. The phase out of the credit occurs at slightly higher amounts than the $8,000 credit. The phase out of the credit occurs between $125,000 and $145,000 for single taxpayers and between $225,000 and $245,000 for married filing joint returns. Taxpayers must be 18 years or older and must not be claimed as a dependent on someone else's tax return. Taxpayers will be required to furnish a copy of the closing statement as proof of purchase. There are special rules for members of the military and foreign service. The credit does not have to be repaid unless the home is sold or ceases to be a principal residence within a three year period from the date of purchase.

Mortgage Insurance

In a further attempt to help home sales, a new provision for mortgage insurance was enacted for tax years 2007 thru 2010. Homeowners who have paid less than 20% down are generally required to purchase mortgage insurance. Under the provisions of this enactment, individuals can deduct the cost of mortgage insurance as home mortgage interest for the years 2007 through 2011. This deduction is phased out for taxpayers with an AGI exceeding $100,000 ($50,000 for a married taxpayer filing separately).[13]

Qualified Residence Interest

Homeowners have long been able to deduct mortgage interest as an itemized deduction, along with real estate taxes and state income taxes. Millions of taxpayers can itemize their deductions primarily because of these three deductions. If mortgage interest and real estate taxes were not specifically included as allowable itemized deductions, most taxpayers would be forced to settle for the "Standard Deduction," and would pay more in income taxes to the federal government – significantly more in some cases. Qualified, and thus deductible, residential interest includes any interest incurred to acquire, construct, or improve a qualified residence. [14] A qualified residence includes the taxpayer's principal residence plus one other residence chosen by the taxpayer. In order to meet the residence test, the taxpayer must have personally used the property more than the greater of 14 days or 10% of any rental days during the year. The limitation for qualified acquisition indebtedness is $1,000,000 ($500,000 married filing separate).

In addition, taxpayers can deduct interest on home equity indebtedness (a home equity loan). Any use of the proceeds is permissible. In general, home equity indebtedness is limited to the lesser of $100,000 or the FMV of the residence less the acquisition indebtedness. Any indebtedness in excess of the $1,000,000 (for the qualified residence interest) or $100,000 (for home equity interest) limits is treated as personal interest and is nondeductible.[15]

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[13] I.R.C. § 163 (h)(3)(E).

[14] I.R.C. § 163 (h).

[15] See I.R.S. Publication 936, *Home Mortgage Interest Deduction*.

Real Estate Taxes

Taxpayers can deduct the real estate taxes they pay as an itemized deduction.[16] If real estate taxes are escrowed with a lender the time of the deduction is determined by when the taxes are actually paid to the taxing authority, not when the money is paid to the escrow agent. The assessment must be classified as a tax on the real estate and not as a fee. There is no limit on the amount or number of residences that qualify for the deduction. For property sold during the year, the taxes must be apportioned between the buyer and seller based on days of ownership. The taxes are generally deductible based on this apportionment. If a buyer pays real estate taxes that are those of the seller, they must be added to the basis of the home and are non deductible. If the seller pays any share of the buyer's real estate taxes, the buyer can still deduct them and must reduce the basis in the home.

Mortgage Interest Credit-2008 and 2009

This provision is available for first time homebuyers whose income is generally below the median income for the area in which they reside.[17] The original provision applied only to the tax year 2008. It has been extended and is effective for the 2009 year as well. This tax break could aid those homeowners who are close to paying off, or have already paid off, their mortgages and therefore probably will not benefit from itemizing their deductions. To be eligible for the credit the taxpayer must get a mortgage credit certificate from either a state or local government agency. Form 8396 is available to compute the credit. Taxpayers need to remember that their itemized deductions amount must be reduced by the amount of the credit claimed. Because of current economic conditions it is doubtful that this provision will be widely used in the near future. At a time when it is difficult for the most qualified candidates to obtain a mortgage loan, it is unlikely that many

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[16] I.R.C. § 164.
[17] I.R.C. § 25.

mortgages will be issued to less qualified or higher risk applicants, including most low income candidates.

Office in the Home Deduction

Taxpayers frequently use part of their residence as an office to support a business activity. In order to qualify for a home office deduction, a taxpayer must use the home office *regularly* and *exclusively* as (1) a principal place of business, or (2) as a location to meet with customers. This would also include administrative and management activities associated with the trade or business, such as consulting with other persons about a particular matter or sending out bills and other correspondence. In general, if a taxpayer is an employee, the office in the home must also be for the convenience of the *employer*. This test makes it difficult for an employee who otherwise has an office (e.g., a professor) to qualify for a deduction.

Expenses directly related to the office in the home, e.g. painting the office or replacing the carpet, are deductible in full. Indirect expenses, e.g. electricity, insurance, depreciation, must be allocated using either the total rooms in the home or square footage.

Home office expenses for employees are miscellaneous itemized deductions, subject to the 2% floor. Home office expenses for self-employed individuals are deductions “for” AGI. The deduction is limited to the taxpayers’ net income from the business computed before the home office expense deduction. There is an ordering scheme for the expenses. Allocable mortgage interest and real estate taxes are considered first, then other non-basis affecting expenses (e.g. utilities, insurance, etc.) and lastly, allocable depreciation. In short, the home office expense deduction cannot create or add to a loss from the business activity. Any loss disallowed by this rule is carried over to later years subject to the same business income limitation. Home office expenses are an area the IRS has closely monitored in the past.

Taxpayers should make sure they have complete documentation as to both the qualifying use and expenses.

Energy Tax Credits

Included in the American Recovery and Reinvestment Act of 2009 were provisions that extended many energy efficiency tax credits through 2010. Many of these qualifying areas are applicable to residences. Some go beyond the 2010 tax year.

A taxpayer may claim a credit of 30% of the cost, with a maximum of $1,500, for a range of products that meet required specifications. A credit may be allowed for items such as:

- Energy efficient windows and doors (including storm doors and skylights)
- Insulation
- Water Heaters
- Metal and asphalt roofs
- Heating and Cooling equipment

(This list is not meant to be all inclusive, only representative of some common qualifying expenditures. There are others.)

The credit only applies to an existing home that is your principal residence. New construction and rentals do not qualify. As a general rule, the $1,500 amount is the maximum allowable amount. However, there are exceptions for more advanced and pricey areas. Tax credits are also available in many states.

TAX BENEFITS FROM SELLING YOUR RESIDENCE

There are also some tax benefits from selling your residence. While these benefits are not as numerous as the tax benefits from buying or owning a home, they can have a significant impact on the tax liability of the seller.

Section 121 Gain Exclusion

When a homeowner sells his or her residence there is quite often a capital gain, and this gain is frequently significant. Assuming that the residence was owned for more than one year, any gain on the sale is treated as a long-term capital gain, and long-term capital gain is normally taxed at 15% for taxpayers in tax brackets above the 15% bracket. This means that a taxpayer who sells his or her asset and realizes a long-term capital gain of $80,000 would expect to pay $12,000 in taxes on that gain. However, § 121 of the Internal Revenue Code provides a special tax exclusion for homeowners who sell their residence and realize a long-term capital gain from the sale.

Section 121 allows an individual taxpayer to exclude up to $250,000 ($500,000 if married and filing a joint return) on realized gain from the sale or exchange of a principal residence. This is an *exclusion* from income taxation provision, not a deferral of taxation or a tax credit. The taxpayer is allowed to legally ignore the income. In order to be eligible for this treatment, the taxpayer must have owned and used the residence as his or her principal residence for at least two of the past five years.

The law also includes a provision for prorating the exclusion for those taxpayers who did not live in the house for two of the previous five. This prorating is available for those taxpayers who did not live in the house for two years due to:

- Multiple births from one pregnancy,
- Acquiring a new job that is more than 50 miles from the old job, or
- The taxpayer or a member of his or her family had a major health issue that required moving before the two year requirement was met.

The taxpayer can exclude that percentage of the gain that is equal to the percentage of the two years that the taxpayer lived in the house as his or her primary residence.

There is a change in the law, effective January 1, 2009, that limits this exclusion if the house was used as something other than the primary residence, such as vacation property or rental property. The exclusion is reduced by the percentage of time that the house was used as other than the primary residence, and may affect taxpayers who realize a capital gain on the sale of the primary residence in the future since the homeowner will no longer be able to take advantage of the full tax-free exclusion if there was any non-qualified use of the property prior to its being used as the primary residence. Non qualified uses include use as a second home, a vacation property, a rental or investment property or a trade or business property. Gain must be allocated between qualified and non-qualified use.

For example, assume that a person bought the house in 2009, owned it for 10 years, lived in the home for two years and sold the home in 2019. Under the current provisions of Section 121, only two tenths of the gain would be tax free; the two years in which it was used as a principal residence would be a qualified use while the other eight years would be a non-qualified use. The new rule applies to nonqualified usage after January 1, 2009.

Exclusion of Gain: Debt Forgiveness

Normally, if a lender forecloses on a residence and forgives all or part of the mortgage debt on the home, a taxpayer would be required to include the amount of the debt that was forgiven in gross income. From January 1, 2007 through December 31, 2012, taxpayers who have such "income" may exclude from gross income up to $2 million of debt forgiveness income.[18] In order to take advantage of this exclusion there are some conditions: the debt must be secured by the home foreclosed on; the home must be the primary residence of the debtor; and the debt must have been obtained to acquire, construct, or substantially improve the home.

[18] I.R.C. § 108 (h).

CONCLUSION

Home ownership is a key component of the American dream, and recent tax changes show that this dream is being encouraged as never before. There were already tax provisions on the books that encouraged home ownership. The deductibility of mortgage interest and real estate taxes, the most significant itemized deductions for most individuals, frequently allows the homeowner to itemize deductions, thus decreasing his or her tax liability. Without these deductions most taxpayers would not benefit from itemizing deductions. Instead they would be left with the standard deduction, resulting in greater tax liability.

While these two deductions remain, the current economic climate has caused the federal government to add a number of other provisions to the tax code that provide direct benefit to homeowners, especially “first time” homebuyers, and taxpayers need to be aware of these provisions. The Housing and Economic Recovery Act of 2008 provided a “homebuyer tax credit” (actually this “credit” is an interest-free loan to such homebuyers) of up to $7500 for qualifying buyers. The American Recovery and Reinvestment Act of 2009 also provided a tax credit for first time homebuyers. This Act calls for a refundable tax credit of up to $8,000 for “first time homebuyers,” and is payable to the home buyer even if he or she has no tax liability against which to apply the credit. A $6,500 tax credit has been enacted for repeat homebuyers for 2010. These provisions should operate to attract quite a few buyers into the housing market, and if the mortgage market revives so that mortgages are more widely available, this could be a piece of the stimulus package that really works.

There is a provision making mortgage insurance premiums deductible for home owners who paid less than 20% down. There is also an additional standard deduction provision in place for 2008 and 2009 for home owners who paid real estate taxes but are unable to itemize deductions. Last, but certainly not least, is Internal Revenue Code Section 121, which permits a home seller to exclude up to $500,000 of gain on the sale of a residence, meaning that this amount is non-taxable. This exclusion is an extremely important retirement planning tool, making home ownership an essential part of one's investment strategy.

Some provisions, such as the 2009 refundable credit, are time sensitive; others, such as the deductibility of mortgage interest and real estate taxes, are not. Some are aimed at first time home buyers or low income home owners. Others, like the Section 121 exclusion, require some planning to make sure you are qualified to maximize your benefit. There are already signs that the economic stimulus efforts of the government target home owners and home buyers as integral to reviving the economy, so some time-sensitive provisions may be extended and other provisions may be forthcoming. As a result, all taxpayers and all financial advisors should be aware of the major tax provisions currently in place or contemplated regarding home ownership. It does appear as if Uncle Sam, as embodied in the I.R.S., loves home owners and wants them to be happy.