A Primer on the First Time Home Buyer Tax Credit

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No provision of the American Recovery and Reinvestment Act of 2009 (the "2009 Act") has attracted as much attention as the so-called "First Time Home Buyer Tax Credit." The credit, which is actually a new and improved version of the tax credit which debuted as part of the Housing and Economic Recovery Act of 2008 (the "2008 Act"), is intended to jump start the U.S. housing market by incentivizing certain taxpayers to purchase a new home. However, with Congress and the White House enacting both the 2009 Act and the 2008 Act swiftly, numerous questions have arisen about what, exactly, is covered by these credits. The purpose of this article is to answer many of the basic questions regarding both the 2008 and 2009 versions of the First Time Home Buyer Tax Credit.

Prior Tax Incentives for Home Ownership

Prior to 2008, the two most significant tax incentives for home ownership in the United States were (i) the home mortgage interest deduction and (i) the exclusion of capital gains for the sale of a primary residence.

Home Mortgage Interest Deduction

Section 163(h) of the Internal Revenue Code (26 U.S.C. § 163(h)) allows a home mortgage interest deduction, with several limitations. First, the taxpayer must elect to itemize deductions, and the total itemized deductions exceed the standard deduction (otherwise, itemization would not reduce tax). Second, the deduction is limited to interest on debts secured by a principal residence or a second home. Third, interest is only deductible on up to $1 million of debt used to acquire, construct, or substantially improve the residence, or on up to $100,000 of home equity debt regardless of the purpose or use of the loan.

Capital Gains Exclusion for the Sale of a Primary Residence

Section 121 of the Internal Revenue Code (26 U.S.C. § 121) allows an exclusion of up to $250,000 ($500,000 for a married couple filing jointly) of capital gains on the sale of real property if the owner used it as primary residence for two of the five years before the date of sale.

Difference Between a Tax Credit and a Tax Deduction

One of the most often asked questions regarding the new First Time Home Buyer Tax Credit, whether it be the 2008 or 2009 version, is what is the difference between a tax credit and a tax deduction. A tax credit, in contrast to a tax deduction (such as the aforementioned home mortgage interest tax deduction) is a dollar-for-dollar reduction in what the taxpayer owes. That means that a taxpayer who owes $7,500 in income taxes and who receives a $7,500 tax credit would owe nothing to the IRS. A tax deduction, however, is subtracted from the amount of income that is taxed.

First Time Home Buyer Tax Credit, Part I: The Housing and Economic Recovery Act of 2008

The Housing and Economic Recovery Act of 2008 (the "2008 Act"), designed primarily to address the subprime mortgage crisis, was passed by the United States Congress on July 24, 2008 and signed by President George W. Bush on July 30, 2008. The 2008 Act included the initial version of the First Time Home Buyer Tax Credit. The 2008 version of the tax credit was available for first time home buyers purchasing any kind of home - new or resale - between April 9, 2008 and January 1, 2009 (for purposes of the tax credit the purchase date is the date upon which closing occurs). Under the 2008 Act, a "first time home buyer" is a buyer who has not owned a principal residence during the three (3) year period prior to the purchase (NOTE: for married couples, the law tests the homeownership history of both the buyer and his/her spouse). The amount of the 2008 tax credit was ten percent of the home's purchase price up to $7,500, and the credit was available only for single taxpayers with income of $75,000 or less and married taxpayers filing a joint return with income of $150,000 or less; however, a reduced credit was available for single taxpayers with "modified adjusted gross income" in excess of $75,000 but less than $95,000 and for married taxpayers with modified adjusted gross income in excess of $150,000 but less than $170,000.

The most significant aspect of the 2008 version of the tax credit is the fact that home buyers are required to repay the credit to the government, without interest, over 15 years or when they sell the house, if there is sufficient capital gain from the sale. For example, a home buyer claiming a $7,500 credit would repay the credit at $500 per year. The home owner does not have to begin making repayments on the credit until two years after the credit is claimed. So if the tax credit was claimed on the 2008 tax return, a $500 payment is not due until the 2010 tax return is filed. If the home owner sold the home, then the remaining credit amount would be due from the profit on the home sale. If there was insufficient profit, then the remaining credit payback would be forgiven. In essence, the 2008 version of the tax credit acted as an interest-free loan from the Federal government.

First Time Home Buyer Tax Credit, Part II: The American Recovery and Reinvestment Act of 2009

The American Recovery and Reinvestment Act of 2009 (the "2009 Act"), signed into law by President Barack Obama on February 17, 2009, contained an overhauled version of the First Time Home Buyer Tax Credit. The 2009 version of the tax credit increased the credit to $8,000 and was made available for first time home buyers (defined the same as in the 2008 Act) who purchase a home on or after January 1, 2009 and before December 1, 2009. The income limits set out in the 2008 Act were retained in the 2009 Act.

The most significant difference between the tax credit in the 2009 Act is that the home buyers are not required to repay the credit to the government.

Other Frequently Asked Questions About the Tax Credit

Does a contract for deed purchase qualify for the tax credit?

At present, there is nothing to suggest that an otherwise qualifying purchase in which a contract for deed is utilized would not be a purchase for which a home buyer meeting the definition of a first time home buyer could claim the tax credit, so long as the purchase is not otherwise excluded (as discussed hereinbelow).

Does a purchase from a related person qualify for the tax credit?

You cannot claim the credit if you acquired your home from a "related person", which includes: (i) your spouse, ancestors (parents, grandparents, etc.) or lineal descendants (children, grandchildren, etc.); (ii) a corporation in which you directly or indirectly own more than 50% in value of the outstanding stock of the corporation; (iii) a partnership in which you directly or indirectly own more than 50% of the capital interest or profits interest.

If a single person (Taxpayer A) qualifies as a first-time homebuyer at the time he/she purchases a home with someone (Taxpayer B) that is not a first-time homebuyer and then later that year they marry each other, is the credit still allowed?

Eligibility for the first-time homebuyer credit is determined on the date of purchase. If Taxpayer A, a first-time homebuyer, buys a house and then later that year marries Taxpayer B, not a first-time homebuyer, the credit is allowable to Taxpayer A. Taxpayer A may take the maximum credit.

Taxpayer A is a single first-time home buyer. Taxpayer B (parent) cosigns for A and does not qualify. Both names are on the mortgage. Can Taxpayer A claim the credit and, if so, how much?

Taxpayer B is not a first-time homebuyer and cannot claim any portion of the credit, but A may claim the entire credit ($7,500 for purchase in 2008; $8,000 for purchase in 2009), if the home was purchased as Taxpayer A's primary residence.

A taxpayer owned her principal residence. Several years ago, she decided to relocate to a rented apartment, but did not sell the former residence. Instead, she rented it out to tenants. Now the taxpayer plans to buy another house and make it her new principal residence. Does she qualify for the first-time homebuyer credit?

A taxpayer who owned rental property within the past three years is still eligible for the credit. The taxpayer cannot have owned and used a home as his or her principal residence within the last three years.

If husband and wife wanted to sell the home that the wife owned when they got married, and the husband had not owned a home within the past three years, could he qualify as a first-time homebuyer for the credit even though the wife would not qualify?

No. The purchase date determines whether a taxpayer is a first-time homebuyer. Since the wife had ownership interest in a principal residence within the prior three years, neither taxpayer may take the first-time homebuyer credit. Section 36(c)(1) of the Internal Revenue Code requires that the taxpayer and the taxpayer's spouse not have an ownership interest in a principal residence within the prior three years from the date of purchase. The husband may not take the credit even if he filed on a separate return.

Conclusion

The 2008 version of the First Time Homebuyer Credit, with its repayment requirement, did not provide the necessary spark to ignite a recovery in the United States housing market. The 2009 version is an improvement over the original 2008 version, but time will tell if the other factors necessary to a housing turnaround (access to credit, number of qualifying buyers) allow the 2009 version of the tax credit to be of any greater significance to the hoped-for recovery.