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TAX AND BUSINESS ADVISOR

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TAX AND BUSINESS Alert™

October 2008

Temporary Credit for First-time Homebuyers

The recent American Housing Rescue and Foreclosure Prevention Act of 2008 (Housing Act) created a temporary credit to encourage home ownership. This new credit is for first-time homebuyers and can be as large as $7,500 ($3,750 for those who use married filing separate status), but is limited to 10% of the home's purchase price.

Eligibility for the credit is limited to those who have not owned a principal residence in the U.S. during the three-year period that ends on the purchase date. In the case of a married couple, both spouses must pass this test.

The credit is generally available for a principal residence purchased after April 8, 2008, and before July 1, 2009. In the case of a newly constructed home, the purchase date is considered to be the date the taxpayer moves in.

Qualified homebuyers should note there are significant drawbacks with this credit. It is phased-out or completely eliminated if the taxpayer's modified adjusted gross income (MAGI) is too high. The phase-out range for married joint filers is between MAGI of $150,000 and $170,000 ($75,000 and $95,000 for unmarried individuals and married individuals who file separately). In addition, the taxpayer must repay the credit amount (without interest) over 15 years starting with the second year after the year the credit is claimed. Each year's repayment amount is treated as an addition to the homeowner's tax liability for that year. (So, the credit really functions as an interest-free loan.)

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If the home is sold, or if the taxpayer stops using it as the principal residence before the credit has been repaid, an accelerated repayment rule may apply. If so, the unpaid credit balance must be paid with the individual's tax return for the year when the triggering event occurs. However, the amount due under the accelerated repayment rule cannot exceed the gain from selling the home to a third party if such a sale is the triggering event.

Please call us if you have questions about the new credit, how to compute your MAGI, or any other tax planning or compliance issue.

Tax Calendar

October 15—Personal returns that received an automatic six-month extension must be filed today and any tax, interest, and penalties due must be paid.

—Partnerships that received an additional six-month extension must file their Forms 1065 today.

October 31—The third quarter Form 941 (Employer's Quarterly Federal Tax Return) is due today and any undeposited tax must be deposited. (If your tax liability is less than $2,500, you can pay it in full with a timely filed return.) If you deposited the tax for the quarter in full and on time, you have until November 10 to file the return.

—If you have employees, a federal unemployment tax (FUTA) deposit is due if the FUTA liability through September exceeds $500.

December 15—Calendar-year corporations must deposit the fourth installment of estimated income tax for 2008.

Temporary Property Tax Deduction for Non-itemizers

Thanks to a provision in the recent Housing Act, for 2008 only, an unmarried taxpayer who doesn't itemize can add up to $500 of state and local real property taxes to his or her "normal" standard deduction amount. Married joint filers can add up to $1,000 to their standard deduction.

Among those who will benefit from this new provision are retired homeowners who don't itemize deductions because they no longer have deductible mortgage interest, but are still subject to state and local real property taxes on their homes.

New Online Payment Reporting Requirement

Congress is concerned that businesses are evading billions of dollars in taxes by not reporting or under-reporting electronic (e.g., credit card) sales transactions. To collect lost tax revenue attributable to these transactions, legislators included a provision in the recently enacted Housing Act. It will require credit and debit card issuers and third-party settlement organizations to report sales-related information to the IRS.


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Beginning in 2011, the new law will require debit and credit card issuers and electronic payment processors like PayPal to file aggregate transaction reports with the IRS. Information that must be reported includes the gross amount paid to the merchant during the year along with the merchant's name, address, and taxpayer identification number (TIN). Starting in 2012, back-up withholding at 28% will apply if the bank or payment organization doesn't have the merchant's TIN. Card issuers will be required to provide a copy of the report to the business.

Mandatory reporting will not go into effect until 2011, giving banks and other reporting organizations time to gear up for these new requirements. When fully implemented, this new law gives the IRS a way to compare what the bank or reporting organization is paying a business with what the business is reporting on its tax return. The new reporting requirements are expected to generate nearly $10 billion in additional tax revenue over a 10-year period.

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Changes to the Home Sale Gain Exclusion

Many taxpayers bought a second home, such as a vacation home, with the intention of later converting the second home into their principal residence. Under pre-2008 Housing Act law, those taxpayers could have excluded up to $250,000 ($500,000 for certain joint filers) upon a later sale of that former vacation home as long as the two-year ownership and use tests for the exclusion were satisfied. However, the Housing Act recently changed the method for recognizing post 2008 gain on the sale of a principal residence formerly used as a vacation or second home.

Specifically, the new rule makes a portion of the gain from selling the residence, the *nonqualified use period*, ineligible for the gain exclusion privilege. A property's nonqualified use period equals the amount of time **after** 2008 during which the property is not used as the taxpayer's principal residence. However, periods of nonqualified use don't include temporary absences that aggregate to two years or less due to changes of employment, health conditions, or other unforeseen circumstances to be specified in future IRS guidance.

Example 1: Nonqualified use leads to additional taxes.

Floyd bought a vacation home in an exclusive area on January 1, 2005. On January 1, 2011, he converts the property into his principal residence, and he and his wife live there for all of 2011 and 2012. On January 1, 2013, he sells the home for a $450,000 gain. Floyd's total ownership period is eight years (2005–2012). However, the two years of post-2008 use as a vacation home (2009–2010) count against him and result in a nonexcludable gain of $112,500 (2/8 × $450,000). Floyd must report the $112,500 as capital gain income on his 2013 federal tax return and pay the resulting federal income tax. If Floyd files jointly, he won't owe any federal income tax on the remaining $337,500 of gain ($450,000 – $112,500) because it's completely sheltered by the exclusion.

Example 2: Nonqualified use has no impact.


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Sandy, a single person, bought a vacation home on January 1, 2001. On January 1, 2011, she converts the property into her principal residence and lives there for all of 2011 and 2012. On January 1, 2013, she sells the home for a $360,000 gain. Sandy's total ownership period is 12 years (2001–2012), but the two years of post-2008 use as a vacation home (2009–2010) result in a nonexcludable gain of $60,000 (2/12 × $360,000). Sandy can claim the $250,000 home sale gain exclusion against the remaining $300,000 ($360,000 – $60,000) gain, leaving a $50,000 taxable gain. The end result is that Sandy must report a total gain of $110,000 (the nonexcludable gain of $60,000, plus the $50,000 gain in excess of the home sale gain exclusion).

Even before the new nonexcludable gain rule, Sandy would have had to report taxable gain of $110,000 ($360,000 – $250,000). Since the $110,000 gain that she would have had to report anyway exceeds the $60,000 nonexcludable gain, the new nonexcludable gain rule has no impact on Sandy.

To minimize the amount of taxable gain from the sale of one of these homes, it is essential that taxpayers keep accurate records of all the money invested in home improvements (before and after it became the taxpayer's principal residence).

Please call us to discuss this important provision and what might be done prior to year-end.

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Payments in Lieu of Dividends

Some investors with margin accounts may get an unpleasant surprise at tax time. When the owner of stock lends that stock to a short seller who uses it to cover a short sale, any dividends paid while the loan is outstanding will be sent to the short seller's buyer.

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To compensate the lender of the stock for any missed dividends, the short seller pays him or her substitute payments in lieu of dividends. This is extremely important because these substitute payments are not actually dividends, do not qualify for the reduced tax rate (15% maximum), and could be taxed at a rate as high as 35%.

Example: Payments in lieu of dividends.

Merryl's margin account with Super Brokers holds 500 shares of Best Bank, Inc., her only investment. Barney, also a customer of Super Brokers, owns no Best Bank stock, but wants to sell 500 shares short. He believes Best Bank's stock price will fall, and he will be able to cover his short position profitably. To facilitate the short sale on January 2, 2008, Super Brokers borrows 500 shares of Best Bank stock from Merryl's account and sells it in Barney's account. On October 1, 2008, Barney covers his short position and the Best Bank stock is restored to Merryl's account. Merryl was unaware of these transactions.

During 2008, Best Bank declares and pays quarterly dividends of \$1 per share on Merryl's stock totaling \$2,000 (500 shares × \$1 × 4 quarters) for the year. While the short sale was open, Barney was required to pay Merryl substitute payments totaling \$1,500 (500 shares × \$1 × 3 quarters). In January 2009, Merryl will receive a statement from Super Brokers indicating that, in 2008, she received \$500 in qualified dividends and \$1,500 in substitute payments in lieu of dividends. The substitute payments are not eligible for qualified dividend treatment and the 15% maximum tax rate; they may be taxed as high as 35%.

Planning Tip: Most standard brokerage agreements allow the broker to lend out stock held in a margin account. Investors may be unaware that their stock was loaned, since it did not affect the amount of quarterly payments they received. Taxpayers with dividend-paying stocks in a margin account should consider rescinding their permission to loan their shares or consider moving those stocks to a cash account to avoid this issue.