Tightened home sale exclusion and other revenue raisers in the 2008 Housing Act

Dear Client,

To pay for the $15.1 billion of housing tax incentives in the recently enacted "Housing Assistance Tax Act of 2008" (the Housing Act), Congress passed several offsetting revenue raisers, including a requirement that banks provide information returns reporting annual credit card sales to IRS and to merchants, a provision requiring homeowners to pay tax on gains made from the sale of a second home to reflect the portion of time the home was used as a vacation or rental property, and a provision delaying for one year a "worldwide interest allocation provision" that would result in lower taxes for some multinational companies. Here are the details of these revenue-raising provisions.

Payment card and third party network information reporting

For returns for calendar years beginning after 2010, the new law requires banks and online payment networks to file an information return with IRS reporting the gross amount of credit and debit card payments a merchant receives during the year, along with the merchant's name, address, and taxpayer identification number (TIN). Reporting is also required for third party network transactions. Information reporting for third party network transactions will be required only for merchants that have (1) annual credit and debit card transactions exceeding $20,000 in the aggregate, and (2) an aggregate number of such transactions during the year that exceeds 200.

Home sale exclusion rules tightened

Most homeowners are aware of the home sale exclusion, a provision of the tax laws which provides that homeowners who sell their principal residence typically don't need to pay taxes on as much as $500,000 of their gain if they meet certain conditions. (The $500,000 exemption is the maximum exclusion for a married couple filing jointly; taxpayers filing individually get an exemption of up to $250,000.) To be eligible for the full exclusion, a taxpayer must have owned the home—and lived in it as his or her principal residence—for at least two of the five years prior to the sale. Because of the "principal residence" requirement, vacation or second homes normally don't qualify for the exclusion. However, in what some saw as a loophole, the law permitted taxpayers to convert their second home to their principal residence, live in it for two years, sell it, and take the full $250,000/$500,000 exclusion available for principal residences, even though portions of their gains were attributable to periods when the property was used as a vacation or second home, not a principal residence.

The new law closes that "loophole" by requiring homeowners to pay taxes on gains made from the sale of a second home to reflect the portion of time the home was not used as a principal residence (e.g, vacation or rental property). The amount taxed will be based on the portion of the time during which the taxpayer owned the home that the house was used as a vacation home or rented out. The rest of the gain remains eligible for the up-to-$500,000 exclusion, as long as the two-out-of-five year usage and ownership tests are met. The new law in effect reduces the exclusion based on the ratio of years of use as a principal residence to the total time of ownership. For example, if a taxpayer owned a vacation home for ten years, but lived in it as a principal residence only for the final two years prior to sale, the maximum available exclusion would be reduced by four-fifths. Accordingly, a $400,000 gain on the sale that would be eligible for the full exclusion under pre-Act law would be reduced by four-fifths, to $80,000.

The good news for current owners of second homes is that the new law is not retroactive. The tightening applies only to sales after 2008. Plus, any periods of personal or rental use before 2009 are ignored for purposes of the provision. Also, the new law doesn't change the rule that allows homeowners to take advantage of the homesale exclusion every two years. Taxpayers can still “home hop” with full tax exclusion if they only own one home at a time. Moreover, the taxpayer still qualifies for capital gain treatment on the amount of gain that cannot be excluded.

Delayed implementation of worldwide allocation of interest

In 2004, Congress provided taxpayers with an election to take advantage of a liberalized rule for allocating interest expenses between U.S. sources and foreign sources for purposes of determining a taxpayer's foreign tax credit limitation. Although enacted in 2004, this election was not scheduled to be available to taxpayers until tax years beginning after 2008. The new law delays the phase-in of this new liberalized rule for two years (to tax years beginning after 2010). Special transition rules apply in the first year that the liberalized rule phases in.

I hope this information is helpful. If you would like more details about these provisions or any other aspect of the new law, please do not hesitate to call.