Repayment of the Homebuyer Tax Credit After Destruction of the Property or Other Involuntary Conversion

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Summary

Taxpayers who purchased a principal residence in 2008-2010 (and in some cases, 2011) may have qualified for a tax credit under Section 36 of the Internal Revenue Code—the first-time homebuyer credit. This credit was amended several times with changes being made to the amount of the credit, the requirements for qualifying for the credit, and the requirements for repaying the credit. These details are available in CRS Report RL34664, *The First-Time Homebuyer Tax Credit*, by (name redacted).

Generally, taxpayers claiming the credit based on a 2008 credit are required to repay the credit over a 15-year period beginning with the 2010 tax return. Taxpayers who purchased after 2008 generally are not required to repay the credit.

However, repayment of the credit may be accelerated when the taxpayer no longer uses the property as the principal residence. For those who purchased property in 2008, acceleration means that any outstanding credit balance must be repaid with the tax return for the year in which the taxpayer ceased using the property as the principal residence. For those who purchased after 2008, the credit must be repaid in full if the taxpayer ceased using the property as the principal residence within the 36 months immediately following the date of purchase.

There are several exceptions to the repayment requirements. This report focuses on the exception due to involuntary conversion and the limitation based on gain.

The term "involuntary conversion" includes either the partial or complete destruction of the property due to a casualty such as a fire, flood, or tornado. Alternatively, the term may mean the loss of some or all of the property by theft or condemnation, which would include a sale under threat of condemnation. Generally, an involuntary conversion will not trigger acceleration of repayment in the tax year in which the involuntary conversion occurs.

Under the exception for involuntary conversions, taxpayers who have received the homebuyer tax credit have two years from the date of the involuntary conversion to replace the property and, thereby, avoid acceleration of repayment. However, those who purchased in 2008 will need to continue repaying one-fifteenth of their credit annually in the interim. If a taxpayer does not replace the residence within the allowed two-year period, the outstanding credit balance generally would be included in the tax liability for the tax return for the year in which the two-year period expires. However, repayment of the credit could be limited by the gain realized on the involuntary conversion.

If the taxpayer realized a loss on the involuntary conversion, there would be no obligation to repay the outstanding credit balance. If the taxpayer realized a gain, but the gain was less than the outstanding credit balance, the credit repayment would be limited to the amount of gain. That lower amount would be added to the taxpayer's tax liability for the year in which the two-year period expired. In either case, the taxpayer would have no obligation to repay any remaining credit balance in future years.

This report includes an **Appendix** with questions that are representative of questions being raised by constituents in areas that have been affected recently by flooding and are applicable to other sorts of involuntary conversions.

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Section 36 of the Internal Revenue Code (IRC) provides for a credit for many taxpayers who bought a principal residence in 2008, 2009, or 2010.[1] The amounts of the credit vary depending upon whether the property was purchased in 2008 or was purchased later and, for purchases made after 2008, whether the purchaser qualified for the "long-time resident" exception.[2] Credits based on purchases made in 2008 generally must be repaid over a 15-year period.[3] Those for subsequent years' purchases generally are not subject to repayment.[4] However, Section 36(f)(2) provides for acceleration of the repayment in certain circumstances if the taxpayer ceases to use the property as a principal residence.

For credits based on purchases after 2008, acceleration of repayment means that the entire credit must be repaid if taxpayers cease using the purchased properties as their principal residences within the 36 months following the purchase.[5] For credits based on a 2008 purchase, acceleration of repayment means that the outstanding balance of the credit becomes due.[6] In each case, the repayment is calculated and included as tax on the tax return for the tax year in which the property ceased to be the taxpayer's principal residence.

There are several exceptions to these repayment provisions.[7] This report addresses the exception for involuntary conversions[8] of the property,[9] as well as the limitation on repayment based on gain (if any) realized on the disposition of the property as it applies to involuntary conversions.[10]

Repayment of the Homebuyer Tax Credit After an Involuntary Conversion

Generally, an involuntary conversion will not trigger acceleration of repayment in the tax year in which the involuntary conversion occurs. Under the exception for involuntary conversions, taxpayers who have received the homebuyer tax credit have two years from the date of the involuntary conversion to replace the property and, thereby, avoid acceleration of repayment. For those who purchased their homes in 2008, the involuntary conversion will not suspend their existing duty to repay the credit over a 15-year period. Those who purchased property in 2008

[1] In limited circumstances the credit may be available to those purchasing a principal residence in 2011. For a detailed description of the credit as originally enacted as well as subsequent changes, please refer to CRS Report RL34664, *The First-Time Homebuyer Tax Credit*, by (name redacted).

[2] 26 U.S.C. §36((b)(1)(D).

[3] 26 U.S.C. §36(f)(1).

[4] 26 U.S.C. §36(f)(4)(D)(i).

[5] 26 U.S.C. §36(f)(2), (4)(D)(ii).

[6] 26 U.S.C. §36(f)(2).

[7] 26 U.S.C. §36(f)(4).

[8] The term "involuntary conversion" includes either the partial or complete destruction of the property due to a casualty such as a fire, flood, or tornado. Alternatively, the term may mean the loss of some or all of the property by theft or condemnation, which would include a sale under threat of condemnation. 26 U.S.C. §1033(a). In this context, the term "condemnation" generally refers to the process through which a governmental entity exercises its right of eminent domain. For general background on condemnation in this context, please refer to CRS Report RS22189, *Condemnation of Private Property for Economic Development: Kelo v. City of New London*, by (name redacted).

[9] 26 U.S.C. §36(f)(4)(B).

[10] 26 U.S.C. §36(f)(3).

and received the maximum $7,500 credit were required to begin repayment of the credit at $500 per year beginning with their 2010 tax returns. If the property was destroyed or otherwise involuntarily converted in 2011, they still would be required to repay $500 on their 2011 and 2012 tax returns. Only acceleration of repayment is affected by an involuntary conversion.

Although the acceleration provision is not triggered in the year of the involuntary conversion, the involuntary conversion must nonetheless be reported to the Internal Revenue Service (IRS) on the tax return for the year in which the involuntary conversion occurs. This is done on Form 5405. The form requires taxpayers to report any disposition or change in the use of the property on which the credit was based. On the 2010 Form 5405, two options apply to involuntary conversions. The first (line 13f) states, "My home was destroyed, condemned, or disposed of under threat of condemnation and I acquired or plan to acquire a new home within 2 years of the event (see instructions)." The second (line 13g) states, "My home was destroyed, condemned, or disposed of under threat of condemnation and I do not plan to acquire a new home within 2 years of the event (see instructions)." Even if the taxpayer does not currently intend to replace the property within two years, accelerated repayment is not due until the tax year for the year in which the two-year replacement period expires.

Limitation on Repayment Based on Gain

In some cases, a taxpayer may be unable or unwilling to replace a home within the two-year replacement period that provides an exception to the acceleration of repayment. In some of these cases, repayment may not be necessary due to the limitation based on gain.[11]

A taxpayer may have gain from an involuntary conversion due to either insurance proceeds (in the case of property that has been damaged or destroyed), condemnation awards, or selling price (in the case of property that has been sold under threat of condemnation). In this case, the taxpayer who does not replace the principal residence within the two years allowed must determine whether there was a gain or loss realized on the property.[12]

Section 36(f)(3) limits the repayment of the homebuyer credit to the amount of gain from the disposition of the property. If there is a loss or no gain, no accelerated repayment is required.[13] However, for purposes of determining gain on the disposition, the property's adjusted basis[14]

[11] 26 U.S.C. 36(f)(3).

[12] Where there is gain, taxpayers may be required to recognize that gain as well as accelerate repayment of the homebuyer tax credit. However, taxpayers may avoid recognition of the gain if they replace the property within the replacement period allowed by Section 1033. Generally, this replacement period expires two years after the end of the tax year in which any portion of the gain is first realized. 26 U.S.C. §1033(a)(2)(B). Thus, it is slightly longer than the replacement period provided by Section 36. Additionally, Section 1033(h)(1)(B) extends the Section 1033 replacement period to four years for a taxpayer's principal residence if it was damaged or destroyed by a federally declared disaster. There is currently no provision that would similarly extend the Section 36 replacement period when a federally declared disaster was the cause of the involuntary conversion. Thus, a taxpayer who replaced a principal residence three years after its destruction might be required to accelerate repayment of the homebuyer credit, but not be required to recognize any gain that had been realized.

[13] Even if there is no gain, there would be no refund of any amounts already repaid on a credit based on a 2008 purchase. The limitation applies only to the accelerated repayment.

[14] For a discussion of "basis" and adjustments to basis, please refer to CRS Report RL34662, *Tax Basis: What Is It? Why Is It Important?*, by (name redacted).

must be reduced by the total amount of the homebuyer credit that was claimed.[15] When there is a gain, that gain would be compared to the outstanding balance of the homebuyer credit. The smaller of the two would be the amount that is added to tax as accelerated repayment of the credit in the year in which the two-year replacement period expires.

[15] For examples of the calculations in determining the limitation of accelerated repayment based on gain, please refer to CRS Report RL34664, *The First-Time Homebuyer Tax Credit*, by (name redacted).

Appendix. Frequently Asked Questions Regarding Repayment of the Homebuyer Tax Credit After Damage or Destruction of the Taxpayer's Residence[16]

1. My principal residence was destroyed by flooding in 2011. Do I have to repay the outstanding balance of my homebuyer credit with my 2011 tax return?

> No. The destruction of your home is an involuntary conversion. The homebuyer tax credit provisions include an exception to the repayment acceleration requirements when the property is destroyed.
>
> - If, within two years of the date your property was destroyed, you replace your principal residence with another that would have qualified you for the credit if acquired in 2008, repayment of your credit will not be accelerated.
> - If you do not replace the residence within this two-year period, your credit will be accelerated, but will be reported on the tax return for the tax year in which the two-year period expires.
> - Despite the involuntary conversion, if your residence was purchased in 2008, you must continue to repay the usual amount ($500 per year if the credit was $7,500) with your tax returns.

2. My residence was not completely destroyed by the flooding, but it was severely damaged. I will have to move out of it while it is being repaired. Do I have to repay the outstanding balance of my homebuyer credit with my 2011 tax return?

> No. Generally, you do not abandon your principal residence due to temporary absences; therefore, it is likely that you would not be considered to have ceased using the property as your principal residence even if you actually move out of it while it is being repaired. Additionally, your property does not need to be completely destroyed for there to be an involuntary conversion; therefore, the involuntary conversion exception (explained above) would also apply.

3. My house was destroyed and was in a federally declared disaster area. Does this mean that repayment of my credit will not be accelerated if I replace my house within four years?

> No. The involuntary conversion exception for acceleration of repayment of the homebuyer tax credit requires you to replace the property within two years. There currently is no provision to expand that replacement period when the property is within a federally declared disaster area.

[16] Answers provided were compiled by CRS using the Internal Revenue Code and sources available from the Internal Revenue Service, including Form 5405 and its instructions. These answers are not intended as either legal or tax advice. Guidance provided is based on currently available information, which is subject to change. Taxpayers whose residences have been damaged or destroyed should seek professional tax advice before filing their tax returns.

4. My house was destroyed or damaged in 2011. Do I have to do anything special when I file my 2011 tax return?

> Yes. You must file Form 5405 with your tax return. On it, you will enter the date on which the damage or destruction occurred and indicate that your house was damaged or destroyed (rather than sold, converted to business or rental use, or abandoned). You will also need to indicate whether you currently intend to replace your property within two years.

5. If I say that I am not going to replace my house, does it mean that I will owe a lot more in taxes for 2011?

> No. You are indicating that you currently do not intend to replace the property. If you do not replace the property, the accelerated repayment of the tax credit will not be reported on your tax return until 2013. If you change your mind and do replace the property within two years, there would be no accelerated repayment requirement.

6. I purchased my house in 2008 and it was destroyed in 2011. I started repaying the credit on my 2010 tax return. What do I need to repay in 2011 and subsequent years?

- You will need to continue paying your scheduled repayment amount ($500 if the credit was $7,500) in 2011 and 2012.
- If you replace your home within two years after its destruction, your repayment will not be accelerated. You will continue repaying your scheduled repayment amount each year.
- If you do not replace your house within the two-year replacement period, you generally would need to repay the outstanding balance on your credit ($6,000 if originally $7,500), showing it on your 2013 tax return. However, that repayment may be reduced or eliminated depending on whether there was a gain from the involuntary conversion.
    - If there was no gain, you would not have to repay any more of the credit.
    - If the gain was less than the outstanding balance on the credit, your repayment would be the amount of the gain.
    - For purposes of calculating this gain, you would be required to reduce your cost basis in the house by the original amount of the credit.

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