Recapture Tax
Frequently Asked Questions

<u>Should I Use the MCC Program or the Bond Program?</u>
Nothing in the recapture tax provision should prevent a borrower from using the MCC program or the bond program, or prevent lenders, builders, or real estate professionals from recommending them. The financial benefits of homeownership, including deductions for mortgage interest payments and taxes, the benefit of the MCC, the bond program's down payment and closing cost assistance, may outweigh the possibility that the borrower may have to pay a recapture tax sometime in the future.

<u>What is the Federal Recapture Tax?</u>
It's a federal tax that a borrower may be required to pay from the net profit they receive from the sale of their home. If they have to pay Recapture, it would be due when they file their federal income tax for the year in which they sell their home. The maximum recapture tax is 6.25% of the original principal balance of the loan or 50% of the gain on the sale of the home, whichever is less.

<u>Will the borrower have to pay a Federal recapture tax?</u>
Most applicants will not have to pay. They **<u>will not</u>** have to pay a recapture tax if any of the following events occur:
They own their home for more than 9 years.
They sell or otherwise dispose of their home within 9 years of acquiring it, but do not make a profit on such sale or disposition.
They sell or otherwise dispose of their home within 9 years of acquiring it, but their household income at the time of such sale or disposition does not exceed a certain pre-established amount.

<u>What does a substantial increase in income mean?</u>
Federal maximum income limits apply to the purchase of your home. Certain regulations automatically increase these maximums at the rate of 5% per year for Recapture. If at the time you purchase your home your income is near the federal maximum, annual income increases would have to exceed 5% per year before you would be subject to Recapture. If your income is considerably below the federal maximum, your income can increase at a greater rate before you would be subject to Recapture.

<u>What determines how much the actual recapture tax will be, if any?</u>
First, the date of sale or transfer.
Second, the borrower's income in relation to the "adjusted qualifying income" in the year of sale or transfer.
Third, the gain from sale or transfer.

<u>How do you calculate the "adjusted qualifying income"?</u>
First, determine the borrower's household income size at the time the home is sold or transferred. Next, select the maximum income limit that would have applied to that household size at the time the home was purchases. This number, compounded by 5% per year from the date of purchases until the date the home is sold or transferred is the "adjusted qualifying income".

<u>Are there advantages to selling the home later during the nine-year recapture period?</u>
Yes. The maximum recapture amount increases during the first five years of ownership to its maximum in the fifth year. The amount then decreases 20% per year through the ninth year. If the sale occurs after the ninth year, there is no recapture tax.

What happens if the loan is assumed?
If the sale or transfer occurs within the first nine years of ownership, the original borrower pays the recapture tax, if applicable, and a new nine-year period begins for the purpose of applying a new recapture tax to the assuming purchaser.

Is recapture due if the borrower dies within the nine-year period?
No. A death transfer is not a sale or transfer for the purposes of recapture.

In the case of divorce, who is responsible for the recapture tax?
A divorce settlement is not a sale or transfer for the purposes of recapture. Whoever receives the home in the divorce settlement pays any recapture tax due as a result of a subsequent sale or transfer if within the nine-year period.

What if the home is destroyed as the result of a fire, flood, or other natural disaster?
If the home is destroyed and borrower rebuilds on the same site within two years after the year in which the insurance proceeds are received, no recapture is due at that time.

In the event that the borrower owes a recapture tax, to whom do I pay it and when?
If any tax is due, it is paid to the IRS when they complete their Federal income tax return for the tax year in which they sold or otherwise disposed the home. For example, if they sold or otherwise disposed your home in 2005, the tax would be paid when they file their 2005 Federal income tax return.

Will recapture completely eliminate a borrower's gain from the sale of the home?
Fortunately no. The recapture tax can never exceed 50% of the gain.

Is Recapture dependent on the profit a borrower makes when they sell their home?
Yes. However, most borrowers who make a profit probably will not owe Recapture. A borrower may have a profit and avoid recapture if their income does not exceed the allowable income in the year they sell their home.

How can the borrower determine if they will have to pay Recapture?
There is no way to predict the exact tax liability, if any; since it is based upon the borrower’s situation at the time they sell their home. It will depend on their income, family size and the amount of their net profit at the time they sell their home. In any event, if they stay in their home for nine years, they will never owe any Recapture.

Can the borrower refinance their loan without paying the Recapture Tax?
Yes; a borrower may refinance their loan at any time. Refinancing a loan will not activate the Recapture Tax, nor will it cancel the Recapture Tax provision should they later sell their home within nine years of the original mortgage loan closing date.

Should the borrower seek additional advice?
For answers to specific questions about calculating potential tax liability, please seek assistance from a professional tax advisor or the IRS. The toll free telephone number of the IRS is 800-829-1040.