

VA Lenders Handbook (VA Pamphlet 26-7), Chapter 4, Topic 3 — Income Taxes and Other Deductions

Register va-m26-7-ch04-t03

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3. Income Taxes and Other Deductions Change Date February 22, 2019 • This chapter has been revised in its entirety. a. Income Tax and Social Security Deductions Determine the appropriate deductions for Federal income tax and Social Security using the “Employer’s Tax Guide”, Circular E, issued by the Internal Revenue Service (IRS). Determine the appropriate deductions for state and local taxes using similar materials provided by the states. The income tax should be based upon the borrower’s residence and what is documented in the guide to the IRS, and not solely the amount claimed on the paystub. An active-duty servicemember’s LES may have a different state tax deduction than the state where the active-duty servicemember will be purchasing a residence or refinancing. Select the state listed on the LES for the state taxes to be considered in state tax deductions. The lender may consider the borrower’s potential tax benefits from obtaining the loan (for example, mortgage interest deduction) in the analysis. To do so: • determine what the borrower’s withholding allowance will be, using the instructions and worksheet portion of IRS Form W-4, Employee’s Withholding Allowance Certificate, and • apply that withholding number when calculating Federal and state income tax deductions on VA Form 26-6393, Loan Analysis, then • document the change in deductions in Item 47, Remarks, on VA Form 26-6393, Loan Analysis. Continued on next page VA Pamphlet 26-7, Revised Chapter 4: Credit Underwriting 4-33 3. Income Taxes and Other Deductions, continued b. Income Tax Credits from Mortgage Credit Certificates (MCC) MCCs issued by state and local governments may qualify a borrower for a Federal tax credit. The Federal tax credit is based on a certain percentage of the borrower’s mortgage interest payment. Lenders must provide a copy of the MCC to VA with the loan package which indicates: • documentation verifying any expenses charged by the local government entity for the program which is listed on the Closing Disclosure Statement, and the percentage to be used to calculate the tax credit, and if applicable, the amount of the indebtedness. The certified indebtedness can be comprised of a loan incurred by the borrower to acquire a principal residence or a qualified home improvement rehabilitation loan. There is an IRS annual limit on the tax credit equal to the lesser of the borrower’s maximum tax liability or \$2,000. Calculate the tax credit by applying the specified percentage to the interest paid on the certified indebtedness. Then apply the annual limit. Example: The MCC shows a 30 percent rate and \$100,000 certified indebtedness. The borrower will pay approximately \$8,000 in annual mortgage interest. The borrower’s estimated total Federal income tax liability is \$9,000. Calculate the tax credit as follows: Step Procedure 1 30 percent of \$8,000 = \$2,400 2 Apply the IRS annual \$2,000 limit 3 The tax credit will be \$2,000 This allows use of \$167 (one-twelfth of \$2,000) as income to qualify the borrower. If the mortgage on which the borrower pays interest is greater than the amount of certified indebtedness, limit the interest used in the tax credit calculation to that portion attributable to the certified indebtedness. Since these programs are offered by state and local government(s), pre- approval by VA is not required for the borrower to participate in the program. The lender

is responsible to determine all eligibility requirements are met by the borrower to participate in the program. Continued on next page VA Pamphlet 26-7, Revised Chapter 4: Credit Underwriting 4-34 3. Income Taxes and Other Deductions, continued c. Other Deductions from Income Include any costs for job-related expenses, child care, significant commuting costs, and any other direct or incidental costs associated with the borrower's or spouse's employment. For children up to the age of 12 years, the lender is responsible for determining if there are any child care expenses for the borrower(s). VA Pamphlet 26-7, Revised Chapter 4: Credit Underwriting 4-35

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