Buying a Home

If you're like most people, your home is the largest investment you'll make in a lifetime. It's a long-term investment that plunges most homeowners into instant debt, but it also provides ongoing tax deductions, such as mortgage interest and property taxes. To take full advantage of these deductions, it's important to keep accurate records of your expenses. In addition to the purchase price, you should keep the following on file:

- Closing costs, such as abstract fees, title and search fees, recording fees, survey fees, and transfer taxes.
- Points paid, loan origination fees, maximum loan charges, loan discount or discount points.

Generally points paid at closing are deductible in the year of purchase, regardless of who pays them, unless you elect to amortize them over the term of the loan.

Tax Deductions

Many new homeowners expect a new home to lower their taxes. Some are disappointed to find out that they can't itemize deductions in the first year because they only incur mortgage interest and property taxes for part of the year.

- The lending institution will issue Form 1098 showing interest paid for the calendar year.
- For mortgage balance(s) of less than $1,000,000 ($500,000 if filing separately) you can deduct the mortgage interest for your main home and a second residence. In order for the mortgage interest to be deductible, the loan must be secured by the home.
- If the home is not the security for your loan (i.e., if you borrowed money from a relative), you cannot deduct the interest.
- Generally, points paid for the purchase of the main home are currently deductible. Points paid on a second residence must be amortized over the term of the loan.
- You can arrange for a home equity loan of up to $100,000 and still deduct the interest.

Note: Exceeding these limitations will result in a limited interest deduction.

- You can deduct assessed property taxes in the year you pay them, even if you saved monthly in an escrow account.
- In the year of transfer, each party is liable for part of the property taxes.
- Back taxes you pay on the property become part of your acquisition cost rather than a current deduction.

Home Improvements

Homes require upkeep. Some of the work is ordinary maintenance, and some is expended to make improvements. It's important to keep track of the amounts spent on improvements by keeping the receipts. These expenses increase the total cost invested in your home. If the upkeep increases the value, rather than maintains the value, it is considered an improvement.

- Normal painting and wallpapering are repairs unless done as part of a renovation project that increases the home's value as a whole.
- Fixing the roof may be a repair, but replacing it is an improvement.
- Some examples of other improvements include landscaping, a new driveway, new windows, fencing, or adding a storage shed.

Selling a Home

- When establishing a selling price, factor in the cost invested in your home.
- To calculate your gain or loss on the sale, you'll need the cost invested.
- If the sale results in a loss, it is a non-deductible personal loss.
- If the sale results in a gain, you may be able to exclude the gain up to $250,000.
- You must own and use the property as a principal residence for at least two of the last five years to take advantage of the exclusion. You couldn't have used the exclusion for any house sold in the previous 24 months. A reduced exclusion is available if you had to sell the home because of a job change, health reasons, or unforeseen circumstance.
- The excludable gain increases to $500,000 if you are married and lived with your spouse in the house for two of the previous five years.
- If you used any portion of your house for business or rental at any time since May 7, 1997, some of the gain will be taxable.
- For sales after December 31, 2008, the exclusion does not apply to any gain allocated to periods of nonqualified use.
- You are not required to exclude the gain on your residence; you may make the election not to exclude by paying tax in the year of sale. You might consider this if you plan to sell another residence that would qualify for the exclusion within two years and the gain would be larger.

- Planning is important. If you have high income and large taxable gain on the sale, you may want to receive payments under the installment sale method. By doing so, only the gain from payments received in the current year would be taxable. (If you need the proceeds right away, this option is less desirable.)
- You may want to consider receiving the entire proceeds, paying the tax, and investing the money.
- Your tax professional or investment consultant can help you weigh your options.

Divorce

- Often the ownership of a home changes with divorce. The home may be sold to a third party or become the sole property of one spouse.
- If one spouse receives the house, no sale occurs for tax purposes. The cost of the house stays the same despite paying money to the other spouse.
- If the home is sold, each owner must report the sale. If the title is shared, both will report their portion of the sale on their individual returns. If one spouse took over ownership, that spouse has the sole reporting responsibility despite a decree that may assign a portion of the proceeds to the ex-spouse.
- If joint ownership is retained after the divorce, both spouses may be able to take advantage of the $250,000 exclusion. Ownership and occupancy by one taxpayer will also qualify the ex-spouse.

Physical or Mental Incompetency

- The exclusion may still apply if you become physically or mentally incapable of self-care and have occupied the home for at least 12 months out of the past 60 months. Time spent in a nursing home is counted as occupancy of the residence in order to exclude the gain on sale. You must maintain ownership during this period.

Summary

- Coupled with potential tax deductions, home ownership is now more rewarding than ever before.
- Consulting your tax advisor can be to your advantage when making home ownership decisions.

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Home Ownership and Taxation