HOMEOWNER'S

TAX GUIDE

IMPORTANT TAX INFORMATION EVERY HOMEOWNER SHOULD KNOW

COURTESY OF

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INTRODUCTION

U.S. taxpayers have enjoyed specific tax benefits on home ownership since personal income tax was introduced by the 16th amendment in 1913. While these benefits may not be the primary reasons motivating a person to buy a home, they are still tangible and not available to tenants.

A principal residence, according to IRS, is the place you live or expect to return. You may only have one principal residence at a time. The confusion comes because a taxpayer can deduct the interest and property taxes on two homes on the Schedule A of their tax return. Only one of the homes is the principal residence and the other is a second home which is an investment property.

Rental property, also known as section 1231 property, is used for income purposes. It includes homes, condos, apartments, shopping centers, office buildings, warehouses and any improved property that generates rental income. It's eligible for qualified exchanges.

Vacation property is rental property that is used for personal purposes less than 14 days or less a year or 10% of the total time it is rented.
Investment property is real estate primarily held for an increase in value. It can be improved property or vacant land. Income tax on the gain may be deferred through the use of qualified exchanges.

NOTE: The information contained in the guide is for information purposes only. Consult with your tax professional before making decisions that can affect you individually based on your specific situation.

MORTGAGE INTEREST DEDUCTION

Acquisition Debt is the borrowed amount used to buy, build or improve a principal residence or second home. Under the Tax Cut and Jobs Act, mortgages taken after 12/14/17 are limited to a combination of $750,000 on the first and second homes. The mortgage interest on this debt is tax deductible when itemizing deductions.

It is a dynamic number that is reduced with each payment as the unpaid balance goes down. The only way to increase acquisition debt is to borrow money to make capital improvements.

Prior to the new law, homeowners could additionally borrow up to $100,000 of home equity debt for any purpose and deduct the interest when itemizing deductions. Mortgage interest on home equity debt has been repealed through 12/31/2025 unless it is for capital improvements.

Acquisition debt cannot be increased by refinancing. Some confusion occurs because mortgage lenders are concerned in making home loans that will be repaid according the terms of the note and using the home as collateral. That does not include making a tax-deductible mortgage. Another thing that adds confusion to the issue is that the lenders will annually report how much interest was paid in a year but only the amount that is attributable to acquisition debt is deductible.

It is the responsibility of the taxpayer to know what part of their mortgage debt is deductible. The challenge becomes more difficult after a cash-out refinance. Homeowners should keep records of all financing and capital improvements and consult with their tax professional.

A mortgage placed on a home within 90 days of its purchase date is considered acquisition debt. This could be an important thing to be aware of because occasionally, a buyer will pay cash for a home fully intending to put a mortgage on the home later and expect to deduct the interest. If a mortgage isn't placed on the home within the first 90 days, the acquisition debt is considered zero.

POINTS

Points are a financing term representing one percent of the mortgage. If a $100,000 mortgage had three points attached to it, it would be 3% of the $100,000 or $3,000.

Points are considered pre-paid interest and therefore deductible in some situations.

Points are deductible by the buyer when they are paid to buy, build, or improve a principal residence. The points may be paid by the buyer or the seller. Points are considered paid by the borrower, if the amount paid in earnest money, down payment, or impounds are equal to or greater than the amount of points paid.

Points are amortized over the life of the mortgage if they are used to refinance a principal residence. If $3,000 is paid in points to refinance a home for 30 years, the homeowner can deduct $100 per year in interest. The balance of points can be deducted in the year the mortgage is paid in full.

Points paid by the seller for the benefit of the buyer may not be deducted as interest by the Seller. The Seller can treat the points as any other selling expense to arrive at the net selling price of the property.

Points are not deductible in full when a home is refinanced. Only the portion of the points that represent new borrowed funds used to buy, build or improve the home would be deductible. The balance of the points paid on a refinance would be deducted ratably over the life of the mortgage.

STANDARD OR ITEMIZED

Taxpayers can decide each year whether to take the standard deduction or their itemized deductions when filing their personal income tax returns.

Beginning in 2018, the standard deduction, available to all taxpayers, regardless of whether they own a home, is $24,000 for married filing jointly and $12,000 for single taxpayers.
Let's look at an example of a couple purchasing a $300,000 home with 3.5% down at 5% interest. The first year's interest would be $14,630 and property taxes are estimated at 1.5% of sales price would be $4,500.

The interest and property taxes would provide a combined total of $19,130 which is less than the $24,000 standard deduction. Unless this hypothetical couple has more itemized deductions like charitable contributions, they would benefit more from taking the standard deduction.
If the mortgage rate were at 8%, the combination of taxes and interest would be almost $28,000 which would make itemizing the deductions more beneficial.

Property taxes on a principal residence and a second home can be itemized deductions on Schedule A but have been limited under the TCJA of 2017. The limitation is referred to as "SALT" and allows an itemized deduction of up to $10,000 for the total of state and local property, income or sales taxes. This $10,000 limit applies for both single and married filers and is not indexed for inflation.

Tax professionals will compare the itemized or standard deduction alternatives to determine which one will benefit the taxpayer most.

EXCLUSION OF GAIN ON PRINCIPAL RESIDENCE

Homeowners can exclude up to $250,000 of the gain on their principal residence if single and up to $500,000 if married filing jointly. During the five-year period ending on the date of the sale, the taxpayer must have:

- » Owned the home for at least two years
- » Lived in the home as their main home for at least two years
- » Ownership and use do not have to be continuous nor occur at the same time

During the two-year period ending on the date of sale, the taxpayer is not eligible if they excluded the gain on sale of another home.

If the gain on the sales exceeds the exclusion amount, the balance is taxed at the long-term capital gains rate. Capital assets, such as a home, that are owned for more than 12 months are subject to the favorable long-term capital gains rate which is lower than the ordinary income rate or marginal tax bracket.

Federal Tax Bracket	10%	12%	22%	24%	32%	35%	37%
Long-term cap gains rate	0%	0%	15%	15%	15%	15%	20%

COST BASIS OF A HOME

The basis of a home is the cost of the home and is used to determine the tax liability. During the ownership, the basis can increase or decrease depending on adjustments. A typical example could be:

Purchase Price:	$150,000
Plus allowable closing costs:	$1,700
Plus capital improvements:	$25,000
Adjusted Basis:	$176,700

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HOME RECEIVED AS INHERITANCE

The basis of the home becomes the fair market value on the date of the decedent's death as established by the executor with the aid of an appraisal or letter of value from a licensed real estate professional. The "stepped up" basis benefits the person inheriting the home by eliminating the gain because the basis would equal the fair market value.

Example of Home Received as Inheritance

Decedent's basis in home: $100,000
Fair market value of home at time of death: $250,000
Stepped up basis in inherited home: $250,000
Potential gain avoided: $150,000

Surviving Spouse Example

Basis in jointly owned home $100,000
Fair market value of home at spouse's death $200,000
Surviving spouse's new adjusted basis $150,000

SALE OF HOME BY SURVIVING SPOUSE

Special consideration is made by IRS for the sale of a jointly-owned principal residence after the death of a spouse. He or she may qualify to exclude up to $500,000 of gain instead of the $250,000 exclusion for single people if certain requirements are met. The sale needs to take place no more than two years after the date of death of the spouse.

Surviving spouse must not have remarried as of the sale date.
The home must have been used as a principal residence for two of the last five years prior to the death.

The home must have been owned for two of the last five years prior to the death.
Survivor can count any time when spouse owned the home as time they owned it and any time the home was the spouse's residence as time when it was their residence.
Neither spouse may have excluded gain from the sale of another principal residence during the last two years prior to the death.

If you have been widowed in the last two years and have substantial gain in your principal residence, it would be worth investigating the possibilities. Time is a critical factor in qualification. Contact your tax professional for advice about your specific situation. See IRS Publication 523 – surviving spouse.

HOME RECEIVED AS A GIFT

If the donor's adjusted basis at the time of the gift was more than the fair market value of the home, the basis is the same as the donor's adjusted basis at time of the gift. If the donor's adjusted basis at the time of the gift was Equal to or less than FMV at that time and you received the gift after 1976, the basis is the same as the donor's adjusted basis plus the part of federal gift tax paid that is due to the net increase in value of the home.

Example of Home Received as a Gift

Donor's basis in home $100,000
Fair market value of home at time of gift $250,000
Donee's basis in home $100,000
Potential gain $150,000

GIFT OR INHERITANCE

A person called into a radio talk program with a situation that was troubling to the caller and disturbing based on the potential tax liability that may have been avoided.

The caller's elderly father had deeded his home to his daughter a few years earlier because, in his mind, his daughter was going to get the home eventually and this would be one less thing to be taken care of after his death. The daughter didn't really care because the father was going to continue to live in the home and take care of it so that it would be no expense to her.

Obviously unknown to either the father or the daughter, transferring the title of a home from one person to another could have significant tax implications. In this case, when the father "gave" the home to his daughter, he also gave her the basis in the home which is basically what he paid for it. If she sells the home in the future, the gain will be the difference in the net sales price and her father's basis which could be considerably higher than had she inherited it.

If the home was purchased for $75,000 and worth $250,000 at the time of transfer, there is a possible gain of $175,000. However, when a person inherits property, the basis is "stepped-up" to fair market value at the time of the decedent's death. If the adult child inherited the property at the time of the parent's death, their new basis would be $250,000 or the fair market value at the time of death and the possible gain would be zero.

In most cases, there are less tax consequences with inheritance than with a gift. There are other factors that may come into play but being aware that there is a difference between a gift and inheritance is certainly an important warning flag that would indicate expert tax advice should be sought before any steps are taken.

THE TAX DIFFERENCE IN SECOND HOMES

A principal residence and a second home have some similar benefits, but they have some major tax differences. A principal residence is the primary home where you live and a second home is used mainly for personal enjoyment while limiting possible rental activity to a maximum of 14 days per year.

Under the 2017 Tax Cuts and Jobs Act, the Mortgage Interest Deduction allows a taxpayer to deduct the qualified interest and property taxes on a principal residence and a second home. The interest was reduced from a maximum of $1,000,000 combined acquisition debt to a maximum of $750,000 combined acquisition debt for both the first and second homes.

The gain on a principal residence retained the exclusion of $250,000/$500,000 for single/married taxpayers meeting the requirements. Unchanged by the new tax law, the gain on second homes must be recognized when sold or disposed of.

Tax-deferred exchanges are not allowed for property used for personal purposes such as second homes. Gain on second homes owned for more than 12 months is taxed at the lower long-term capital gains rate.

OVERLOOK RECORDKEEPING

Homeowners are familiar that they can deduct the interest and property taxes from their income tax returns. They also understand that there is a substantial capital gains exclusion for qualified sales of up to $250,000 if single and $500,000 for married filing jointly. However, ongoing recordkeeping tends to be overlooked.

New homeowners should get in the habit of keeping all receipts and paperwork for any improvements or repairs to the home. Existing homeowners need to be reminded as well in case they have become lax in doing so.

These expenditures won't necessarily benefit in the annual tax filing but may become valuable when it is time to sell the home because capital improvements raise the basis or cost of the home.

For instance, let's say a single person buys a $350,000 home that appreciates at 6% a year. Twelve years from now, the home will be worth $700,000. $250,000 of the gain will be exempt with no taxes due but the other $100,000 will be taxed at long-term capital gains rate. At 15%, that would be $15,000 in taxes due.

Assume during the time the home was owned that a variety of improvements totaling $100,000 had been made. The adjusted basis in the home would be $450,000 and the gain would only be $250,000. No capital gains tax would be due.

Some repairs may not qualify as improvements but if the homeowner has receipts for all the money spent on the home, the tax preparer can decide at the time of sale. Small dollar items can really add up to substantial amounts over many years of homeownership.

The important thing is to establish a habit of putting receipts for home expenditures in an envelope, so you'll have them when you are ready to sell.

MORTGAGE LOANS FROM RELATIVES

Occasionally, when dealing with close relatives that also might become heirs, signing a note and handling the paperwork properly may seem like a needless effort but it could mean the difference in being able to take a legitimate interest deduction.

Home mortgage interest is deductible only if the loan is a secured debt which involves the buyer signing an instrument like a mortgage or deed of trust that makes the ownership of the home security of the debt.

That instrument must then be recorded or otherwise perfected according to state or local law and the home, in case of default, must be able to satisfy the debt.

In a family situation, a parent, grandparent or other relative may loan a buyer the money to purchase a home because they have money available and it isn't earning much in certificates of deposit. They might offer to loan it for a rate equal to what a conventional lender is charging but without the fees.

While it may appear to be a win-win situation, there could be problems if things are not done correctly. Even if the borrower makes the payments, they are not entitled to an interest deduction unless they meet the three criteria listed above:

1) Sign a debt instrument specifying the terms
2) Securing and record the debt properly and
3) The home is sufficient collateral for the loan.

It would be prudent to consult with an attorney before you sign the final settlement papers to be comfortable that both buyer and the lender relative are complying with IRS regulations.

For more information, see IRS Publication 936 – Home Mortgage Interest.

HOMEOWNER'S TAX WORKSHEET

Part 1 - Basis of Residence

Purchase Price	$
Less Personal Property Items	-
Plus Purchase Costs to be added to Basis	+
Basis at Time of Purchase	$
Plus Capital Improvements	+
Adjusted Basis	$

Part 2 - Computation of Gain

Selling Price of Residence	$
Less Personal Property Items	-
Less Expenses of Sale ***(taken from closing statement)***	-
Net Selling Price	$
Less Basis of Residence Sold	-
Gain on Sale (realized gain) ***(if zero or less, enter zero)***	$
Less Exclusion Allowed	-
Taxable Gain (recognized gain)	$

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HOMEOWNER'S TAX WORKSHEET

Sale of a Principal Residence

The Internal Revenue code allows a homeowner to a specific amount of gain from a principal residence based on a taxpayer meeting certain requirements.

However, most homeowners don't take advantage of all the adjustments in order to keep the gain as low as possible. If the truth could be told, most people's records are so poor that when the time comes to recognize the gain, the calculations probably have to be based on estimates instead of actual numbers.

Rules to be eligible for Exclusion

» Qualifying home must be used as your principal residence two out of the five preceding years. This exclusion does not apply to vacation or 2nd homes.

» Effective for sales on or after May 7, 1997.

» Couples filing joint returns can exclude up to $500,000 of gain on sale of principal residence. Single return filers can exclude up to $250,000.

» Gain in excess of applicable exclusion is taxed at appropriate capital gains rate.

Part 1 - Basis of Residence

Purchase Price - the form starts out with the original purchase price of the home. This would be the price that is shown on the closing statement at the time of purchase.

Personal Property Items - the cost of personal property that was included in the purchase price must be subtracted at this point. If no actual value was assigned to the property at the time of purchase, a conservative estimate should be used.

Purchase Costs - Included here are closing costs that the homeowners paid for the acquisition of the home but were not expensed in the year of purchase. Costs to acquire the loan and reserves for insurance cannot be deducted or capitalized.

Total Basis at Time of Purchase - this is the figure that is arrived at by subtracting the personal property items from the purchase price, then adding the unexpensed closing costs and then, subtracting the cumulative deferred gain.

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HOMEOWNER'S TAX WORKSHEET

Capital Improvements - IRS allows a homeowner to take the costs of capital improvements and add them to the basis of their home in order to accurately reflect the true gain in a property when it is sold. The problem is that many people find it hard to distinguish a capital improvement from a repair.

A repair is considered to be maintenance of an existing item such as fixing a dripping faucet, adding coolant to an air conditioner, or replacing a broken window. However, a capital improvement is something that adds value to the residence either by materially adding features or extending the life expectancy of the improvement.

A good record should be kept of capital improvements and it needs to be documented with receipts and canceled checks. To avoid controversy at some point in the future, a photograph could help prove that the improvement was actually made.

The basic questions to determine if an expenditure qualifies for capital improvement treatment are:

#1 Does it materially add value to the property?
#2 Does it extend the life of the property?
#3 Does it adapt a portion of the home to a new use?

Capital improvements can include such items as landscaping, street assessments, remodeling, swimming pool, counter-tops, and the like. If replacement items are used such as installing carpet where there had previously been carpet, only the upgrade amount can be added. For instance, if the home had a builder's grade of carpet and it was replaced with a more expensive line, only the difference between the builder's grade and the replacement can be added as a capital improvement.

An adjustment for casualty losses can also be made in this location on the form. A casualty loss is any actual monetary loss in value to the property you may have suffered but were not reimbursed for out of insurance proceeds.

Adjusted Basis - the combination of the total basis at time of purchase and the total capital improvements is called the adjusted basis.

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HOMEOWNER'S TAX WORKSHEET

Part 2 - Computation of Gain

Selling Price of Old Residence - the sales price of the property that is being sold is placed in this blank. It is the figure shown on the closing statement and sales contract.

Less Personal Property Items - An adjustment is made to determine the value of the real property being sold. If no actual dollar value was attached to the personal property, the IRS allows the value to be estimated. Unlike the strategy in Part 1, the larger the value of personal property declared here, the smaller the gain. Therefore, don't undervalue personal property.

Expenses of Sale - The sales expenses or sales costs of the old residence are listed here to be subtracted from the sales price of the old residence less personal property items in order to accurately reflect the gain.

Typical fees paid are brokerage fee, loan fees, title insurance, escrow fees, attorney fees, and other miscellaneous fees. Points paid by a seller are not interest but are treated like other sales costs and are basis adjustments.

However, a pre-payment penalty is considered interest and is not reported here but as interest paid on a personal residence and is reported on Schedule A of the 1040 Form.

Net Selling Price - the price that the property sold for less personal property items and expenses of sale in order to accurately reflect what the seller actually received for the property.

Basis of Residence Sold - inserted on this blank is the adjusted basis that was calculated in Part 1.

Gain on Sale - by subtracting the adjusted basis from the net selling price, the gain on sale is ascertained.

Examples of Capital Improvements

Trees	Swimming Pool	Paneling	Patio	Built-in Bar	Dish Antenna
Cabinets	Heating System	Garage Addition	A/C System	Special Assessments	New Flooring
Bookcases	Patio Cover	Room Addition	Deck Installation	Patio Extension	New Roof
Landscaping/Shrubs	Permanent Barbecue	Driveways	Trash Compactor	Complete Repainting	Sun Shades
Heating System	Fencing/Gates	Wallpapering	Storm Windows	Drapery Rods	Walkways
Pet Runs, Kennels	Wall Mirrors	Solar Panels	Carport Addition	Garage Door Opener	Carpeting
Built-in Oven	Renovations	Dead Bolts	Lawn Installation	New Plumbing	Water Heater
Light Fixtures	Burglar Alarm System	Grading Soil	Electric Wiring	Fireplace Addition	Planter Boxes
Water Softener	Basement Finishing	Insulation	Architect Fees	Removing Title Clouds	Shelving
Garbage Disposal	Intercom System	Sidewalks			

For more information on this subject, see IRS Publication 523

CAPITAL IMPROVEMENT REGISTER

List the capital improvements made during the ownership period. Record any item that would not be considered a maintenance item. Later, it can be scrutinized by your professional tax preparer. Keep receipts and cancelled checks to verify the expenditure.

DATE	VENDOR	DESCRIPTION	AMOUNT

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