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Reporting Gains/Losses

Exclusion of Gain:

When you sell your principal home at a gain, you can exclude all (or a portion) of the gain if you meet certain occupancy and holding period requirements. To qualify for this exclusion, you must have owned and occupied the residence for two years out of the five year period that ends on the date of the sale. If you meet those qualifications and are filing a joint return with your spouse, you may exclude up to \$500,000 (\$250,000 for a single individual) of gain from the sale.

A partial exclusion may be allowed even if the two-of-five year ownership and occupancy tests aren't met if the sale is due to a job-related move, health, or certain unforeseen circumstances. If you do not qualify for the full or partial exclusion, there is no deferral privilege and the gain not eligible for exclusion is fully taxable.

NOTE: A second home, such as a mountain cabin or lake cottage, doesn't qualify for the exclusion of gain.

Previously Postponed Gain:

Under prior tax law (generally pre-'98), gain from the sale of a principal residence could be deferred into your replacement residence. Those gains were accumulated from home to home as long as each replacement home cost more than the adjusted selling price (i.e., sales price less expenses of sale and pre-sale "fix-up" costs) of the previous home. Although gain deferral from a principal residence is no longer permitted under current law, the gains deferred under prior law into a home currently being sold must be accounted for.

Sales at a Loss:

Losses from the sales of business or investment properties are normally tax-deductible. However, a loss from the sale of your main home is considered personal in nature, and therefore, unless the law changes, it is not allowed as a deduction. This rule also applies to second homes.

Reporting the Sale:

You no longer need to report the sale of your main home on your tax return unless you have a gain and at least part of it is taxable – i.e., if the gain is greater than your allowed exclusion, the sale is reportable. Otherwise, if the gain is totally offset by the exclusion, the sale should not be shown on your tax return. However, to be certain that no reporting is required, you should provide your tax advisor with the sales documents, cost basis information, etc., to evaluate your situation. You may receive Form 1099-S showing the gross proceeds from the sale, although settlement agents (escrow companies) are no longer required to issue a Form 1099-S for most sales of main homes. If you do receive a Form 1099-S, let your tax advisor review it and determine if it is necessary to report the sale.

Exclusion Qualifications

Under prior law . . . (generally pre-'98), individuals were entitled to a once-in-a-lifetime exclusion of gain from the sale of their principal residence. To qualify for that exclusion, the taxpayer or spouse must have reached the age of 55 prior to the sale, and they must have resided in the home for three of the prior five years. Having exercised that exclusion does not bar a taxpayer from qualifying for the current law exclusion.

Under current law . . . there is no age requirement associated with the exclusion. The period of time the home must be owned and occupied as a principal residence has been reduced to two out of the past five years. In addition, the exclusion amount has been raised to \$500,000 for couples filing jointly and \$250,000 for other individuals. The once-in-a-lifetime limitation has been deleted, thus permitting taxpayers to exclude a gain every two years if they meet all of the other conditions.

CAUTION: Prior law included a provision for the deferral of gain allowing taxpayers to avoid taxation on a gain that was not excludable if their replacement residence met certain qualifications. The new law contains no deferral provisions, thus any gain not excludable is immediately taxable.

Tax Planning and Your Home

The information outlined here is only a brief overview of the tax rules involving home ownership. Since the rules are complicated, if you're thinking of buying or selling your home, or refinancing a home loan, it's best to discuss the plans with your tax advisor to interpret closing documents and to make absolutely certain the transaction meets the necessary qualifications.

The purpose of this pamphlet is to provide current information on tax, financial, and business developments. It suggests general tax planning ideas that may be appropriate in certain situations. The information and opinions are generalizations and may not apply to all taxpayers; it is important that you seek appropriate advice before implementing any of the ideas suggested.

Client
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Home Ownership

Your Best Tax Shelter



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Homeowners Receive Big Tax Breaks

Home ownership can provide you with several important tax benefits:

- Deductions for real estate taxes and home mortgage interest, and
- Gain exclusion if you meet certain occupancy and holding period requirements.

In fact, tax breaks are probably one of the biggest reasons you decided to buy your home in the first place. Unfortunately, some homeowners lose getting the most from their home's tax advantages because they aren't aware that certain limits apply. The purpose of this brochure is to highlight how you as a homeowner can best keep your home's favorable tax edge.

Your Home's Basis

The amount of the gain exclusion permitted under current tax law tends to make most taxpayers forget about keeping track of their home improvements. Don't forget, inflation will take its toll, and in a few years the exclusion limits may not be as significant as they are today, or the law may change again. In either case, it may be appropriate to keep a record of the improvements on your home.

Once you buy a home, you need to begin keeping records related to your home's "basis," i.e., the amount you have spent on the property. If you acquired your home through purchase, your basis is what you paid for it originally, including purchase expenses, PLUS improvement costs you incur while you own it. Keeping track of basis is extremely important in order to accurately report gain or loss if you decide to sell.

For the purpose of computing basis, it's important to distinguish between "improvements" and repairs; only improvement costs add to your basis. Minor repairs like replacing faucet washers, painting a bedroom or patching a hole in the roof don't need to be tracked. In general, improvements are of a more permanent nature than repairs. They enhance the value of your home and are likely to last more than one year. If you make the same improvement more than once, only the most recent improvement adds to your basis.

You should log costs of items like the following in a home improvement record (be sure you keep your backup receipts and canceled checks):

| | |
|----------------------------|------------------------|
| <i>Room additions</i> | <i>Landscaping</i> |
| <i>New driveway</i> | <i>Walkways</i> |
| <i>Fence</i> | <i>Retaining wall</i> |
| <i>Sprinkler system</i> | <i>Swimming pool</i> |
| <i>Exterior lighting</i> | <i>Satellite dish</i> |
| <i>Intercom</i> | <i>Security system</i> |
| <i>Storm windows/doors</i> | <i>Roof</i> |
| <i>Central vacuum</i> | <i>Heating system</i> |
| <i>Central air</i> | <i>Furnace</i> |
| <i>Filtration system</i> | <i>Light fixtures</i> |
| <i>Wiring upgrade</i> | <i>Water heater</i> |
| <i>Soft water system</i> | <i>Insulation</i> |
| <i>Built-in appliances</i> | <i>Kitchen upgrade</i> |
| <i>Bathroom upgrade</i> | <i>Flooring</i> |
| <i>Wall-to-wall carpet</i> | |

Whenever there's doubt about whether an expenditure qualifies as an improvement, make a note of it in your record anyway. That way, the ultimate decision about qualification can be made later when (and if) you decide to sell.

Deductions Related to Your Home

Certainly not all costs related to your home are deductible. For example, unless you use your home for business (e.g., you have an office in your home), costs for insurance, repairs, utility costs, condo fees, etc., aren't deductible. However, you generally will be able to deduct:

- *REAL ESTATE TAXES*
- *HOME MORTGAGE INTEREST*

Keep in mind, however, that home mortgage interest deductions can be limited. Generally, you can deduct the interest from mortgages up to \$1 million dollars on a combination of your first and second homes, provided they were the original loans. As the principal on these loans is paid down, the reduced loan amount becomes the new limitation. If you were to later refinance the home for more than the remaining balance on the original loan, the excess would have to be used for home improvements or qualify under the provisions that allow a taxpayer to borrow up to \$100,000 in home equity. If not, a portion of the interest would not be deductible.

The additional \$100,000 of home equity can only be borrowed from the primary residence and not a second home. As a result, any equity taken from a second home and not used to make improvements on that home would create a situation where a portion of the interest would not be deductible. When used wisely, the \$100,000 equity loan can also be used to finance other purchases where the interest expense would normally not be deductible. An example of this would be a personal vehicle.

Because of the current strict home mortgage deduction limits and the complicated tax rules associated with this tax deduction, be sure to review any home financing plans with your tax advisor before finalizing loan deals.

Loan Points:

A question often comes up about the deduction for points on a home loan. Points are another name for prepaid interest – they may be called loan origination fees or some similar term. One point equals 1% of the loan amount. When points are paid for services a lender provides to set up a loan, the points aren't deductible. However, when the points are paid as a charge for the use of money, the following rules apply:

- As a general rule, points are only deductible over the life of a loan. Say, for example, you paid \$3,000 in points on a 30-year refinance loan. Your tax deduction would be limited to \$100 a year (\$3,000/30 years). If you decided to pay your loan off early, say after 15 years, you could write off the balance of the points (\$1,500) in that year.
- An exception to the general rules lets you deduct, in full, points you pay in connection with obtaining a mortgage to purchase, construct, or improve your main home.
- Seller-paid points can even be deducted by a home buyer, but the amount deducted reduces the home's basis.