

Tax Benefits of Homeownership

Buying a home can be a major expenditure. Fortunately, federal tax benefits are available to make homeownership more affordable and less expensive. There may also be tax benefits under state law.

Mortgage Interest Deduction

One of the most important tax benefits of owning a home is that you may be able to deduct any mortgage interest you pay. If you itemize deductions on your federal income tax return, you can deduct the interest you pay on a loan used to buy, build, or improve your home, provided that the loan is secured by your home. Up to \$1 million of such "home acquisition debt" (\$500,000 if you're married and file separately) qualifies for the interest deduction.

You may also be able to deduct interest you pay on certain home equity loans or lines of credit secured by your home. Up to \$100,000 of such "home equity debt" (or \$50,000 if your filing status is married filing separately) qualifies for the interest deduction. The interest you pay on home equity debt is generally deductible regardless of how you use the loan proceeds. For alternative minimum tax purposes, however, interest on home equity debt is deductible only for debt used to buy, build, or improve your home.

Deduction for Real Estate Property Taxes

If you itemize deductions on your federal income tax return, you can generally deduct real estate taxes you pay on property that you own. For alternative minimum tax purposes, however, no deduction is allowed for state and local taxes, including real estate property taxes.

Points and Closing Costs

When you take out a loan to buy a home, or when you refinance an existing loan on your home, you'll probably be charged closing costs. These may include points, as well as attorney's fees, recording fees, title search fees, appraisal fees, and loan or document preparation and processing fees. Points are typically charged to reduce the interest rate for the loan.

When you buy your main home, you may be able to deduct points in full in the year you pay them if you itemize deductions and meet certain requirements. You may even be able to deduct points that the seller pays for you.

Refinanced loans are treated differently. Generally, points that you pay on a refinanced loan are not deductible in full in the year you pay them. Instead, they're deducted ratably over the life of the loan. In other words, you can deduct a certain portion of the points each year. If the loan is used to make improvements to your principal residence, however, you may be able to deduct the points in full in the year paid.

Otherwise, closing costs are nondeductible. They can, however, increase the tax basis of your home, which in turn can lower your taxable gain when you sell the property.

Home Improvements

Home improvements (unless medically required) are nondeductible. Improvements, though, can increase the tax basis of your home, which in turn can lower your taxable gain when you sell the property.

Capital Gain Exclusion

If you sell your principal residence at a loss, you can't deduct the loss on your tax return. If you sell your principal residence at a gain, you may be able to exclude some or all of the gain from federal income tax.

Capital gain (or loss) on the sale of your principal residence equals the sale price of your home minus your adjusted basis in the property. Your adjusted basis is typically the cost of the property (i.e., what you paid for it initially) plus amounts paid for capital improvements.

If you meet all requirements, you can exclude from federal income tax up to \$250,000 (\$500,000 if you're married and file a joint return) of any capital gain that results from the sale of your principal residence. Anything over those limits may be subject to tax (at favorable long-term capital gains tax rates). In general, this exclusion can be used only once every two years. To qualify for the exclusion, you must have owned and used the home as your principal residence for a total of two out of the five years before the sale.

What if you fail to meet the two-out-of-five-year rule? Or you used the capital gain exclusion within the past two years with respect to a different principal residence? You may still be able to exclude part of your gain if your home sale was due to a change in place of employment, health reasons, or certain other unforeseen circumstances. In such a case, exclusion of the gain may be prorated.

Other Considerations

It's important to note that special rules apply in a number of circumstances, including situations in which you maintain a home office for tax purposes or otherwise use your home for business or rental purposes.

This article is not intended to be exhaustive nor should any discussion be construed as legal, tax, or financial advice.
