

Tax Tips for Homeowners

2017

The tax law gives eligible homeowners a number of tax breaks, but many of the laws are complex and require documentation. Knowing the rules and planning to comply with them could help you save thousands of tax dollars.

Tax Treatment of Costs Incurred in Purchasing a Home

Immediately deductible items include prorated real estate taxes, loan origination fees (points), and prorated mortgage interest. Most everything else is added to your home's basis and includes things like real estate commissions, attorney fees, and recording costs. Often times one of the largest parts of the closing costs are amounts paid to establish escrows for property taxes and insurances. Escrow amounts are not immediately deductible and do not add to your home's basis. Since escrows are merely funds set aside in a separate account, they do not become deductions until your escrow agent actually submits those amounts for payment on property taxes (property insurance is a personal expense and is not deductible when escrowed or paid).

The points you pay on a mortgage are deductible the year you make the purchase. You can deduct any points you paid if you meet the following criteria:

- The loan is secured by your primary residence and the loan was used to buy, improve or build the home;
- The points are computed as a percentage of the loan principal;
- The points are clearly delineated on the buyer's settlement statement; and
- You put cash into your home purchase in an amount at least equal to the points you were charged.

You may also deduct points that a seller paid for you at closing. When a seller pays points for the buyer (or in other words, buys the mortgage rate down) the buyer gets a lower mortgage rate and can claim the point's deduction on their return. However, be advised these points reduce your basis.

Although you may deduct points paid on an original mortgage the year in which they are paid, you also have the option to deduct them ratably over the life of the loan. Keep this in mind if you don't have enough deductions to fully utilize itemizing your points all in one year.

When real property is sold, the buyer and seller must apportion the real estate taxes for the year of sale. The agreement between the buyer and seller concerning who pays the taxes does not necessarily determine who gets to deduct the taxes. This is because a taxpayer cannot deduct real property taxes actually imposed on another taxpayer, unless the buyer pays delinquent taxes imposed on the seller; then that amount is added to his/her basis of the property. Generally, regardless of the taxpayer's overall method of accounting, the date of sale and the real property tax year determine each party's share of the taxes.

Essentially, property taxes must be apportioned between the buyer and seller based on the number of days each held the property during the property tax year. For this reason, if you buy or sell your home during the tax year it will be necessary to trace your real estate tax payments made at closing to your settlement statement.

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Deducting Mortgage Interest

The most substantial tax deduction for many homeowners is the mortgage interest deduction. Mortgage interest on a primary residence (in addition to second residences) is usually tax-deductible (but not necessarily for Alternative Minimum Tax or AMT) for mortgage balances up to \$1 million (\$500,000 if married filing separately). You are also entitled to deduct interest on additional home equity indebtedness of up to \$100,000. That means that in addition to the \$1 million acquisition cost, you can borrow up to another \$100,000 of the equity in your home. This is a change from the pre-1986 tax rule that limited your equity borrowing beyond the purchase price to certain qualified expenses, such as home improvements, medical, and education expenses.

If a mortgage was originally considered to be entirely acquisition indebtedness, then any refinance of that mortgage will continue to be considered acquisition indebtedness, but only to the extent of the original mortgage. Any additional indebtedness, if not specifically used to substantially improve the residence, will be considered home equity indebtedness, subject to the \$100,000 limit for regular tax purposes.

Late payment charges may also be deducted as home mortgage interest if not for a specific service received in connection with your home loan. The same is true for mortgage prepayment penalties. If you pay off your mortgage early and incur a prepayment penalty, you can deduct that penalty as home mortgage interest (subject to the same requirements for late payments).

Acquisition and home equity indebtedness must be secured by a qualified residence. If your adjusted gross income is higher than a certain level, your deductions may be limited.

Deducting Home Mortgage Interest and AMT

Home equity indebtedness is only deductible for Alternative Minimum Tax purposes if used to improve the home (to the extent the equity borrowed does not exceed the original cost of the home). For this reason it may be necessary to track proceeds of home equity loans for AMT purposes. In addition, the definition of a "qualified personal residence" is different for AMT than it is for regular tax, which may eliminate the deduction of interest on acquisition indebtedness for AMT purposes.

Refinancing

If you refinanced last year, you may be able to write-off any points you paid to buy down the mortgage rate. To do so, you deduct part of the points in the year you paid

then, then deduct the remainder ratably over the life of the new loan, (unless part of the new loan is used for home improvements in which case the IRS allows a deduction for a portion of the points allocable to the home improvements). If the loan is paid off prior to maturity (e.g., the residence is sold and the loan paid off, or the loan is refinanced with a different lender), the remaining unamortized balance of the points can be deducted in that tax year. But if the mortgage is refinanced with the same lender, the unamortized "old" points and any new points must be deducted over the term of the new loan.

Deducting Real Estate Taxes

Real estate taxes are annual taxes based on the assessed value of a property and are also tax deductible. You may deduct all property tax payments made on your residence(s) as an itemized deduction as long as that payment is not associated with the expense of a business.

Sale of Your Home

If you make a profit when you sell your principal residence you can exclude up to \$250,000 of gain (\$500,000 for married couples) from your income if you meet certain requirements. The full tax break is only available once every two years. During the five-year period ending on the sale date, you must have owned the home and used it as your principal residence for at least two years.



If you are married and file jointly, the full \$500,000 exclusion is available if both you and your spouse meet the two-year use requirement and haven't claimed the exclusion for another sale within the past two years. You don't necessarily have to own the residence jointly. If you recently married and plan to sell your residence at a gain, don't rule out the possibility of claiming an exclusion just because your spouse excluded a gain on another sale within the past two years. You can still qualify for an exclusion of up to \$250,000 if you meet all the requirements yourself.

Additionally, even if you didn't meet the requirements for the full gain deduction when you sold your prior residence because you didn't meet the time requirement, you may be able to receive a prorated deduction.

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A taxpayer who fails to meet the ownership and use requirements or the “one-sale-in-two-years” requirement is eligible for a partial gain exclusion if the principal residence was sold or exchanged by reason of:

1. a change in place of employment;
2. health; or
3. unforeseen circumstances.

Moving Expense Deductions

Homeowners who have recently relocated for work may be able to write off the cost of moving themselves, their household goods, their vehicles, and other reasonable costs (except meals) associated with the move. The move is subject to distance and time requirements.

The distance rule is a mileage requirement. Your new place of work must be at least 50 miles further from your former place of residence than was your former place of work.



Additionally, following the move you must be a full-time employee of the new employer for at least 39 weeks of the next 12 months. Under certain conditions the time requirement may be waived. Self-employed individuals and members of the armed service may also be eligible for the moving allowance, subject to special rules.

Moving and Multi-state Tax Issues

If you moved from one state to another, chances are that you will be required to file multi-state tax returns. This could bring up a number of complicated tax and reporting issues. An allocation of income must be made between the two states and proper documentation maintained. Please feel free to contact us in order to save yourself time and costs associated with incorrect reporting or double taxation.

Determining the “Basis” of your Home

In laymen’s terms, “basis” refers to money you have invested in your home for which you have not received a tax deduction. The biggest component of your home’s basis is the original purchase price. To calculate “basis” you generally start with the amount you paid for the home when you purchased it or the amount you paid to have it built; then you start adding.

The first addition is usually closing costs. As mentioned earlier not all “closing costs” are immediately tax deductible and need to be added to basis. Actually the bulk of the costs paid at closing are generally not deductible but are added to your home’s basis.

The rest of the additions to your home’s basis are home improvements. Home improvements are the most common increase that occurs to a home’s basis. There are limits on what the IRS considers an improvement.

An improvement must accomplish one of the following three goals:

1. Materially add to the value of your home;
2. Considerably prolong its useful life; or
3. Adapt it to new uses.

Only the actual costs incurred for improvements can be added to your home’s basis. You can’t add a value for your own labor.

There are two other important details about improvements to remember when calculating your home’s basis. First, any improvement must remain with the home when it is sold. The same expense can’t be claimed twice. For example, if you replace a water heater more than once, you may only add the cost of the latest expenditure to basis. Second, you have to distinguish between an improvement and a repair. A repair merely keeps your home in an ordinary and efficient operating condition. It doesn’t add to the value of your home, prolong its life or adapt it to a new use.

Careful timing can transform a repair into a home improvement. Repairs completed as part of an extensive remodeling or restoration of your home are considered improvements, which means they can be added to your basis.

Also, the distinction between an improvement and a repair isn’t always clear. For example, painting either a room or your entire house for the first time is an improvement, meaning the cost can be added to basis. A later repainting of the room or entire house is a repair, and this cost doesn’t increase your basis.

Your basis will be used to calculate any gain on your home upon a sale in the future and keeping accurate records of these items while you own the home is very important.



Second Homes and Vacation Homes

Owning a second residence has more benefits than you may think. You can deduct some of the costs associated with owning the home, such as real estate taxes, personal property taxes, mortgage interest, and points (must be amortized over the life of the loan).

Additionally, if you rent the home for less than 15 days in a twelve month period, you are generally not required to report the income. That amounts to tax-free income!

If you rent the residence for greater than 14 days, your second home may be classified as a rental property and become subject to business tax rules. In order to qualify as a second residence you must occupy the residence for the greater of 14 days or 1/10 of the number of days it is rented.

The tax treatment of vacation homes can be confusing. While vacation homes may seem attractive because of the interest deduction generally allowed for second residences, taxpayers should closely monitor personal and rental use of vacation homes to avoid the potentially unfavorable characterization of "rental property". Interest expense allocable to the rental period of such properties is subject to the passive activity loss rules, while interest expense allocable to personal usage may be nondeductible personal interest (if the property fails to qualify as a residence).

Home Office Expense Deductions

If you have a qualified office in your home, you may be able to deduct costs associated with maintaining the portion of your home exclusively used for business. For example, 100% of your expenses related to the office such as painting and upkeep are deductible, as well as a portion of indirect expenses such as the cost of utilities, maintenance, garbage pickup, as well as a deduction for depreciation.

To qualify, you must use a portion of your home regularly and exclusively for business use. If you are an employee you must be able to prove that you use your home office for the convenience of your employer. If you are a telecommuter you may be able to deduct amounts you pay for items like office supplies even if you don't meet the requirements for a full home office deduction.

Taxpayers with outside work locations may want to shift substantial administrative and management activities to a designated area of their personal residence to qualify for the home office deduction. Otherwise, the IRS may determine that your "office" is actually at your customers' offices.

Simplified Home Office Deduction Rules

There is a simplified method to take a deduction on your home office. Instead, you can deduct \$5 for every square foot of home office space used, up to a maximum of 300 square feet, or \$1,500. Also, when you sell your home in the future, you don't have to recapture depreciation on your home for the years you took the simplified option.

Tax Credit for Going Green

The government is promoting the movement of "going green" as reflected in the Residential Energy Efficient Property Credit. This tax credit is 30% of the cost of alternative energy equipment that you installed on or in your home. This can also include your second home or vacation home, and there is no limit on the amount of credit available for most types of property. If your credit happens to be more than you owe, then you can simply carry forward the unused amount to next year's return. This credit will remain at 30% until 2019 and slowly decrease thereafter.

Improvement Deducted as Medical Expenses

You may find it surprising that you can deduct the cost of adding a swimming pool, elevator, or air conditioner to your home. That is, if the primary purpose of the expense is for the medical care of you, your spouse, or your dependent. You can also deduct the costs related to the operation and maintenance of the addition or improvement as long as the medical reason still exists and the costs are for treating the taxpayer, spouse, or a dependent.

Of course, the IRS wants you to be reasonable. Amounts that you spend for sheer luxury or just for aesthetic reasons are not deductible. Contact us for closer review before moving forward with these renovations.

Davis & Hodgdon Associates CPAs has worked with new homeowners to capitalize on all applicable deductions for more than 25 years. Our accountants have the experience required to make sure that nothing is missed! For more information or to set up an appointment please contact our office at 802-878-1963 or email info@dh-cpa.com.

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