

Tax Advantages of Home Ownership

By Tom Moore, Capital Investment Advisors

Most homeowners realize that there are substantial tax benefits associated with homeownership. Having a working knowledge of the rules relating to the *home mortgage interest deduction* and the *capital gain exclusion* will enable you to implement home purchase, sale and financing strategies that can save you thousands of dollars in income taxes.

Home Mortgage Interest Deduction

The best known homeowner tax benefit is the mortgage interest deduction available on a taxpayer's *qualifying residence*. This deduction – an itemized deduction reported on a taxpayer's form 1040 schedule A – can result in substantial tax savings. The rules relating to the deduction are fairly simple. In discussing deductibility of home mortgage interest, a distinction must be made between *Acquisition Debt* and *Home Equity Debt*.

Acquisition Debt

General Rule: Interest on debt incurred to acquire, construct or substantially improve a taxpayer's primary or secondary residence is deductible.

Limitation: The deduction is limited to interest on up to \$1,000,000 in total combined *acquisition debt* on the taxpayer's primary residence and any secondary residence.

Home Equity Debt

General Rule: Interest on debt other than *acquisition debt* secured by a primary or secondary residence is deductible.

Limitation: The deduction is limited to the interest on debt which equals the lesser of the fair market value of the property or \$100,000.

Some taxpayers may have an unusual primary or secondary residence, such as a motor home, a houseboat or even an airplane. Any of these would constitute a *qualifying residence* as long as it contains kitchen and bathroom facilities.

Example 1

Mary Yetta purchased a \$500,000 primary residence taking out a \$400,000 first mortgage loan. After five years, she had paid down \$50,000 of the loan and the home is now worth \$600,000. She refinances for \$600,000.

The Acquisition Debt portion is \$350,000 (\$400,000 mortgage less \$50,000 pay down). The Home Equity Debt portion is \$250,000 (\$600,000 - \$350,000). Interest is deductible on a total of \$450,000 consisting of the \$350,000 refinanced acquisition debt plus the home equity debt capped at \$100,000.

If Mary used \$75,000 of the \$600,000 refinance proceeds for an addition to the home, the interest on \$525,000 would be deductible consisting of the \$350,000 refinanced

acquisition debt balance plus the \$75,000 in “substantial improvements” plus home equity debt capped at \$100,000.

Example 2

Woody Dunn purchased a home for \$400,000 in cash. A year later he decides to finance the home, taking out a \$350,000 first mortgage.

Woody’s interest deduction is limited to \$100,000 in home equity debt. Since he purchased the home with cash, there was no acquisition debt. If, however, he had mortgage financed the home within 90 days of purchase, he would have been able to deduct interest on the full \$350,000 as acquisition debt (the IRS allows 90 days).

Capital Gain Exclusion

The exclusion of gain from the sale of a taxpayer’s *primary residence* is a major wealth building opportunity for homeowners. Unlike the annual tax savings of the home mortgage interest deduction, tax benefit is realized by excluding gain from the sale of a *primary residence* from taxable income. Unlike the home mortgage interest deduction, the exclusion does not apply to a secondary residence.

General Rule: Taxpayers can exclude from their income up to \$250,000 in gain from the sale of a home owned and occupied as the taxpayer’s *primary residence* for at least two of the past five years. Note:

1. The exclusion is \$500,000 for married taxpayers filing jointly.
2. The gain does NOT have to be used to purchase another home.
3. The two-year occupancy period does not have to be continuous, the taxpayer must simply occupy the residence for an aggregate of two years during the previous five years.
4. Both spouses must meet two year occupancy test.
5. The exclusion can not be claimed more than once within a two year period.

As with most tax rules there are some exceptions. For example, the sale of a home prior to the required two-year time period may be eligible for prorated exclusion in certain “hardship” circumstances including divorce, job relocation, military service or short-term illness.

Example 1

Grant Parks bought Home #1 in March 2000 for \$450,000. Grant lived in Home #1 as his primary residence until April 2001, at which time he rented it to a tenant and moved into Home #2, purchased by Grant for \$400,000, as his primary residence. In May 2003, Grant sold #2 for \$500,000 and moved back into Home #1. In July 2005, Grant sold Home #1 for \$600,000.

For income tax purposes, Grant properly excluded the \$100,000 gain on Home #2 from his 2003 income and properly excluded the \$150,000 gain on Home #1 from his 2005 income.

Example 2

Grant Parks bought Home #3 in July 2005 for \$500,000. In December 2005, his girlfriend, Ansley, moved in. Grant and Ansley were married in May 2006, and Grant put Ansley on the deed, making them joint owners of Home #3. Grant and Ansley sold Home #3 in January 2008 for \$850,000.

In filing a joint 2008 tax return, Grant and Ansley may exclude the \$350,000 gain from the sale of Home #3. With respect to a married couple filing a joint return, only one of the couple must meet the ownership test while both must meet the occupancy test in order to exclude up to \$500,000 in gain from the sale of a primary residence.

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