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The Basics

Home, the mother of all tax shelters

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Owning a house gives you huge tax advantages. And now the IRS has made claiming even more tax breaks easy.

By Jeff Schnepper

You've heard me talk about how owning a home is the world's greatest tax shelter. You can deduct mortgage interest and property taxes. And almost always, you can keep the gains when you sell your home.

Well, thanks to rules made permanent in 2002 and some provisional rules, the Internal Revenue Service has gone and made your home potentially an even greater tax shelter than it was before -- especially if you use your home for your business.

Let's look at all the deductions and benefits you get when you pay homage to the mortgage gods and go into more debt than your parents earned in their lifetimes. We'll start with the bread-and-butter breaks, and then hit the new wrinkles.

Taxes

First, you get to deduct all the real property taxes you pay. That includes all state or local taxes for the general welfare. It doesn't count any trash or garbage collection fees or homeowner association charges specifically stated and billed.

If you're escrowing for the taxes, you get the deduction when your bank makes the payment.

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Even if you're a tenant shareholder in a co-op, you get to deduct your share of any property taxes paid.

There's no limit on the number of properties on which you can deduct taxes paid. If you have 10 homes, you can deduct the taxes on all 10. (But I must note that if your deductions are too great you could be required to use the Alternative Minimum Tax. The AMT is designed to ensure that everyone pays some tax and does so by forcing you to take fewer deductions.)

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Interest

Uncle Sam wants to put you in a home. Sorry, that doesn't sound right. How about, Uncle Sam wants to put you in a house? In any case, our government wants to subsidize your home purchase. It does that by making your interest payments deductible.

Interest paid on the purchase of your principal residence is deductible. You can even finance additional land, adjacent to your home, and deduct the interest as qualified residence interest. You can also deduct the interest you pay to buy a second residence or vacation home.

The personal-interest deduction is limited to the first $1 million of debt. If you plan to spend more than $1 million for your house, call your accountants.

You can also deduct the interest on as much as $100,000 worth of home-equity debt. As long as the house has the equity and the debt is secured by that equity, the IRS doesn't care what you do with the borrowed money. You can use it for whatever you want, including a vacation or a party to celebrate your newfound deductions.

If you're in the 28% bracket, $100 in interest paid only takes $72 out of your pocket. Uncle Sam pays the other $28 in income taxes forgone.

Gain exclusion

Here's where the IRS gave up the farm this past year.

Forget about having to roll over your gain into a new home. Forget about the $125,000 gain exclusion if you're age 55 or older. Both are now ancient history. The new rule is good no matter how old you are. And though the IRS has been accepting it for about two years, the new rule is now permanent (with a few new wrinkles -- the type that are good for you).

If the property was your principal residence for any two of the five years prior to sale, you can exclude from taxes $250,000 in *gain* ($500,000 on a joint return). If you qualify under the 2-out-of-5 rule, you normally sign an affidavit at settlement. If the house sold for less than $250,000/$500,000, the sales amount isn't even reported to the IRS because you have no tax liability on that sale.

This isn't a one-time exclusion. You don't have to buy a new house. You can even rent, and you can get another full exclusion every two years, or whenever you qualify. But, if you have a $250,000/$500,000 gain every two years, I want to meet your real-estate agent and get in on the gold mine.

You can even get a *partial* exclusion based on the time of use and ownership. But you only get the partial exclusion if the sale is because of:

- A change in place of employment, or
- Health reasons, or
- Unforeseen circumstances.

The partial exclusion is based on the maximum exclusion, not on the basis of your actual realized profit. So, say you bought a home for $250,000 and sold it, because of a job change, for a $25,000 profit after only one year.

Because the sale was covered by a change in employment, you get a partial exclusion. It was your principal residence for one year out of two, so 50% of the maximum exclusion, up to $125,000 in total gain, is excluded. Since that's more than the $25,000 gain you actually realized, no tax is due on the sale. That's because you exclude half the maximum allowed, not the gain itself. It's a major tax break. Not many properties are going to appreciate more than $125,000/$250,000 in one year.

The key is to qualify for the partial exclusion if possible. "Change in employment" covers anyone who lives in the household. The person doesn't even have to be an owner of the property. The "change in employment" must be the *primary* reason for the move. There's a "safe harbor" that assumes that it was the primary reason if your new job is at least 50 miles farther from the residence sold than where you used to work.

But if you don't meet the "safe harbor," all is not lost. You'll just have to prove (if you're audited) that it was the primary reason for the move based on the facts and circumstances of your case.

Health reasons include advanced-age-related infirmities, the need to move to care for a family member, or to obtain or provide medical or personal care for a qualified individual suffering from a disease, illness or injury.

Unforeseen circumstances are where the IRS really became consumer-friendly. Safe harbors here include divorce, death, multiple births from the same pregnancy and even a change in employment or self-employment status that results in your inability to pay the costs and living expenses of your household. So, if your income goes down, or even if your spouse or other co-owner's income goes down, you can qualify for a partial or even a full exclusion.

Even if you don't qualify for one of these "safe harbors," you might still qualify on the basis of your specific facts and circumstances.

Home offices

Here's where, in my opinion, the IRS actually crossed the line. But it was in favor of the taxpayer. So I'm not going to complain.

Let's assume you use 20% of your house as a home office, and you deduct depreciation and expenses for working in that part of the house.

In the past, when you sold your house, 20% of the gain wouldn't qualify for the exclusion because that 20% wasn't used as a "residence." It was used exclusively as your office. And check IRS Publication 946 on office property deductions. (See link at left.)

The IRS doesn't care even if you used your home 90% for business as a home office. You can now exclude as much as 100% of your gain, up to the $250,000/$500,000 limit.

You're only going to be subject to tax on the gain to the extent of depreciation taken on the building since May 7, 1997. But that's taxed only at 25%.

Wow! That means, if you qualify, there's no reason not to claim a home office. And I know there are any numbers of people who work out of their homes who don't claim home offices now.

Dorothy was right: "There's no place like home."

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