Charting Your Course to Home Ownership

Home Owner Tax Planning

For many years, the federal government has encouraged home ownership by giving tax benefits to home owners that are not available to renters. Here is a general description of some of the current tax benefits associated with home ownership.

Income Tax Deductions

A tax "deduction" is an amount that can be subtracted from your actual ("net") income to reduce your taxable ("gross") income. In the past you may have taken the standard deduction rather than itemize your deductions on your federal income tax returns. But once you are a home owner, you can deduct the interest you pay on your mortgage and certain other expenses. To do so, you will need to use IRS Form 1040 (the "long form").

Initial Closing Expenses

Certain one-time costs are associated with the purchase of a home and can be deducted from your income tax, such as:

- Origination Fee/Points (percentage of the loan amount)
- Mortgage Interest Discount Points (percentage of the loan amount)
- Pre-paid Interest (collected at closing)
- Pre-Paid property tax (collected at closing)

Home Mortgage Interest

The deduction for interest alone may save you thousands of dollars in federal income taxes. Especially in the early years of your mortgage, the bulk of your monthly mortgage payment is interest. Each monthly payment is divided slightly differently between principal and interest. As time goes on, you pay less and less interest and more principal. The lender will give you a statement each year showing how much interest you have paid and your principal balance at year-end.

If you have both a first and a second mortgage on your house, the interest you pay on both mortgage loans is deductible (within limits).

In your first year as a home owner, your tax break may be even larger since points paid to the lender to obtain your mortgage loan also count as interest. If certain conditions apply, you can deduct the full amount of points in the same year they were paid, even if they were paid by the seller. Points paid to get a

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home improvement loan or a home equity loan may also be fully deductible in the year paid.

You can also deduct as mortgage interest other charges such as late payment fees and prepayment penalties that you pay to your mortgage lender.

Property Taxes

Federal tax law allows a deduction for taxes on real property paid to state or local jurisdictions. This means that as a home owner, your local real estate (or property) taxes are deductible.

Many states also have "**homestead exemptions**." In Louisiana, the first $75,000 of the assessed value of your home is free of property tax.

Rental Property

If part of your home is rented out, the rent you receive must be reported as income for income tax purposes. However, you can deduct from the rent the cost of any repairs and operation expenses (such as the cost of utilities, insurance and advertising for tenants), as well as an annual depreciation allowance. If your deductions are greater than your rental income, you can report a loss (subject to limitations), which will lower your taxable income.

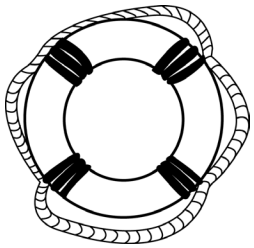
Capital Gains Exclusion

Generally, when you sell something for more than you paid for it, you must pay a capital gains tax on the increase (your profit). Here again, home owners receive special tax treatment.

The Taxpayer Relief Act of 1997 changed the home owner capital gains tax rule so you no longer have to "trade up" to a more expensive home to defer taxes on the gain (profit) from the sale of your home. The new law allows home owners to exclude up to $250,000 of gain ($500,000 for married couples filing a joint return) from the sale or exchange of a principal residence occurring after May 6, 1997. In plain English, that means you pay no taxes on your profit from the sale of your home (up to the above limits).

This exclusion is allowed at any age each time you sell or exchange your home (but not more often than once every two years). You are not required to reinvest in a new home to claim the exclusion.

To be eligible, the home must have been owned and not used as rental property for at least two years out of the five years prior to the sale or exchange. In addition, if there is any rental or business use of your principal residence, you must show gain to the extent of any depreciation allowable.



Life Saver

Consult your tax advisor or IRS publications for detailed information and any recent changes regarding capital gains.

Keeping Records

For tax purposes, it's important to keep accurate and complete records of your home mortgage and home equity loan interest costs, including points (for itemized deductions) as well as your home purchase costs and costs of any improvements you make to your house.

There could be a time when you need to know your home's "basis," the amount used for figuring a gain or loss when you sell it. **The basis is the price you paid for your home adjusted up or down by certain other costs**.

Some of the closing costs you paid when you bought your house also can increase your home's basis when you sell. So don't throw your settlement sheets away.

Although home improvement costs are not tax-deductible, home improvements (but not home repairs) increase your home's basis. Home improvement receipts should be kept for as long as you own that home plus three years.

Home improvements are expenses that add to its value, prolong its useful life or adapt it to new uses. A "repair" keeps the home in an ordinary condition, such as repainting and fixing broken parts. Repairs do not change the basis and are not generally deductible.

Adapted from: Reichel, C. (1998). Your Path to Home Ownership. Baton Rouge, La.: LSU AgCenter.

Additional Resources:
O'Brien, Ph. D., David P. Deciding to Buy a Home: Deciding to Own. Retrieved on April 14, 2008 from http://www.nmhomeofmyown.com/decision/decision_pdf/DecidingtoOwn.pdf

LSU AgCenter Writing Team:
Jeanette A. Tucker, Ph.D., Professor
Deborah L Hurlbert, Extension Associate
Cynthia C. Richard, Extension Agent, Calcasieu Parish
Sheri Richard Fair, Extension Agent, Ascension Parish
Deborah C. Cross, Extension Agent, Iberville Parish
Cynthia B. Stephens, Extension Agent, Ouachita Parish

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Louisiana State University Agricultural Center
William B. Richardson, Chancellor
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Louisiana Cooperative Extension Service
Paul D. Coreil, Vice Chancellor and Director
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