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White Paper

*Income Tax Considerations for Homeowners*

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# Income Tax Considerations for Homeowners

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## Introduction

This discussion applies to your principal residence only.

Home ownership confers many benefits, including federal income tax advantages. In particular, you may be able to deduct your mortgage interest payments. In addition, special rules apply to the tax treatment of points, closing costs, home improvements, and repairs.

## The Housing and Economic Recovery Act of 2008

The Housing and Economic Recovery Act of 2008 (the Act) created two temporary tax benefits for homeowners.

### First-time homebuyer tax credit

The first-time homebuyer credit is a temporary refundable tax credit equal to 10 percent of the purchase price of a home, up to \$7,500 for singles and married couples filing jointly (\$3,750 for married individuals filing separately).

However, this credit is actually an interest-free loan. Two years after you claim this credit, you must start paying it back. The payback can be made over 15 years in equal installments. So, if you claim a \$7,500 credit on your 2008 tax return, you would start paying \$500 a year back with your 2010 return. If you sell the home during the 15-year period, then the remaining credit amount would be due from the profit on the home sale. If there is insufficient profit, then the remaining credit payback will be forgiven. Also, if you die during the 15-year period, the balance will be forgiven.

The credit starts phasing out for taxpayers with \$75,000 of modified adjusted gross income (MAGI) (\$150,000 if married filing jointly). The credit is completely phased out for taxpayers with \$95,000 MAGI (\$170,000 if married filing jointly).

The qualifying home must be purchased on or after April 9, 2008 and before July 1, 2009, and eligible taxpayers must claim the credit on their 2008 or 2009 tax return.

### Additional standard deduction for non-itemizers

The Act allows homeowners to claim an additional standard deduction for property tax if the taxpayer does not itemize. The additional amount that can be claimed is the lower of:

- The amount of real estate property taxes paid during the year to state and local governments; or
- \$500 (\$1,000 if married filing jointly)

This additional standard deduction applies to tax year 2008 only.

## Can you deduct your mortgage payments?

With most mortgages, part of each monthly payment is applied to the outstanding principal on your mortgage loan, and part is applied to the mortgage interest. If you itemize deductions on Schedule A of your federal income tax return, the part that is applied to mortgage interest may be deductible.

### Mortgage taken to buy, build, or improve your home

You may be able to deduct qualified interest you paid on a mortgage to buy, build, or improve your principal home or second home, provided that the loan is secured by your home. More specifically, you may be able to deduct interest on up to \$1 million of such mortgage debt (\$500,000 if you're married and file separately). If your mortgage loan exceeds \$1 million, some of the interest that you pay on the loan may not be deductible.

**Tip:** Different rules apply if you incurred the debt before October 14, 1987. All loans taken on and secured by your primary residence and one second residence prior to October 14, 1987--no matter how the proceeds are used--are considered "grandfathered" debt. All interest paid on such grandfathered debt is deductible, even if the total debt exceeds \$1 million.

**Tip:** Special rules apply to the deduction of interest paid on a home construction loan.

**Tip:** For 2007 through 2010 only, premiums paid or accrued for qualified mortgage insurance is treated as deductible mortgage interest. Qualified mortgage insurance means mortgage insurance provided by the VA, FHA, and Rural Housing Authority as well as private mortgage insurance (PMI). The amount of the deduction is phased out if your AGI exceeds \$100,000 (\$50,000 if married filing separately). This provision does not apply with respect to any mortgage contract issued before January 1, 2007 or after December 31, 2010.

### Home equity debt

You may also be able to deduct the interest you pay on certain home equity loans. However, the rules are different. (Home equity debt involves a loan secured by your main or second home that exceeds the outstanding mortgages on the property.) The interest that you pay on a qualifying home equity loan is generally deductible regardless of how you use the loan proceeds (unless you use the proceeds to purchase tax-exempt vehicles). In other words, the loan doesn't have to be made to buy, build, or improve your residence.

Deductible home equity debt is limited to the lesser of:

- The fair market value of the home minus the total acquisition debt on that home, or
- \$100,000 (or \$50,000 if your filing status is married filing separately) for main and second homes combined

**Example(s):** You bought a home some years ago for \$180,000, taking out a mortgage of \$130,000 to do so. The \$130,000 is considered home acquisition debt. The fair market value of the home has now increased to \$195,000, and the principal balance on the loan has been paid down to \$110,000. You decide to take out a home equity loan of \$90,000. You may deduct interest paid on \$85,000 of the \$90,000 home equity loan. Why? Interest cannot be deducted on the home equity debt that exceeds the difference between the fair market value of the residence (\$195,000) and the principal owed on the acquisition debt (\$110,000) at the time the home equity loan is taken.

## How are points and closing costs treated for tax purposes?

When you buy a home or refinance an existing loan on your home, you'll incur settlement charges. These usually include both points and closing costs, such as attorney's fees, recording fees, title search fees, appraisal fees, and loan preparation fees. The income tax treatment of these settlement charges depends on the type of charge and (in some cases) the type of loan.

### Deducting points when you buy a home

Points are costs that your lender may charge when you take out a loan secured by your home. One point equals 1 percent of the loan amount borrowed (e.g., 1.5 points on a \$100,000 loan equals \$1,500). If you itemize your deductions on Schedule A of your federal income tax return, and if your lender charges the points as up-front interest and in return gives you a lower interest rate on the loan, the points may be deductible.

**Tip:** It doesn't matter whether your lender calls the charge points or a loan (or mortgage) origination fee. If this charge represents prepaid interest, it may be deductible.

If you take out a mortgage to buy or improve your home and pay points, you can deduct the points in the year they're paid if you meet all of the following conditions:

- Your loan is secured by your main home
  - Paying points is an established business practice in the area where the loan was made
  - The points paid were not more than the points generally charged in that area
  - You use the cash method of accounting (most individuals use this method)
  - The points were not paid in place of amounts that ordinarily are stated separately on the settlement statement, such as appraisal fees, inspection fees, title fees, attorney fees, and property taxes
  - The funds you provided at or before closing, plus any points the seller paid, were at least as much as the points charged
  - You use your loan to buy or build your main home
  - The points were computed as a percentage of the principal amount of the mortgage
  - The amount is clearly shown on the settlement statement as points charged for the mortgage.
- The points may be shown as paid from either your funds or the sellers

If you don't meet the above conditions, you must amortize your deduction of the points over the term of the loan. If the loan ends early (because, for example, you sell the home or refinance the mortgage), you may fully deduct the remaining points for the tax year the loan ends. For more information on deducting points, see IRS Publication 936.

**Tip:** If the seller pays your points, they may also be deducted as an up-front interest charge. However, because they are also considered a reduction in the cost of the home, you must lower your cost basis in the home by an amount equal to the points paid by the seller.

## Deducting points when you refinance your mortgage

Refinanced loans are treated differently. The points you pay on a refinanced loan generally must be amortized over the life of the loan. In other words, you can deduct a certain portion of the points each year. But there's one exception: If part of the loan is used to make improvements to your principal residence, you can generally deduct that portion of the points in the year the points are paid.

**Example(s):** Suppose you take a cash-out refinance mortgage for \$100,000 and pay two points (\$2,000). You use \$90,000 to pay off the principal debt owed on the old mortgage, \$4,000 to pay off bills, and \$6,000 to install new kitchen cabinets. Because 6 percent (\$100,000 divided by \$6,000) is used for home improvements, \$120 worth of points (6 percent of \$2,000) may be deducted in the year the loan is taken. The remaining \$1,880 in points must be deducted ratably over the life of the loan.

## Tax treatment of closing costs

Generally, you can't deduct closing costs on your tax return. Instead, you must adjust your tax basis (i.e., the cost, plus or minus certain factors) in your home. If you're buying a home, you'd increase your basis by the amount of certain closing costs that you've paid.

**Example(s):** Your closing costs on a loan you take to purchase a \$200,000 home total \$3,000. Your closing costs would increase your cost basis in that home to \$203,000.

**Caution:** Escrow fees that you pay at closing to cover costs that you must pay later (e.g., hazard insurance premiums) are not added to the basis of your home.

## What is the tax treatment of home improvements and repairs?

Home improvements and repairs are generally nondeductible. However, a distinction is made between improvements and repairs, and they're treated differently for tax purposes.

### Home improvements

Improvements can increase the tax basis of your home (which in turn can lower your tax bite when you sell your home). Improvements add value to your home, prolong its life, or adapt it to a new use. For

example, the installation of a deck, a built-in swimming pool, or a second bathroom would be considered an improvement.

**Tip:** You may be entitled to one or more tax credits for making certain energy-saving home improvements.

## Home repairs

In contrast, a repair simply keeps your home in good operating condition. Regular repairs and maintenance (e.g., repainting your house and fixing your gutters) are not considered improvements and are not included in the tax basis of your home.

**Tip:** However, if repairs are performed as part of an extensive remodeling of your home, the entire job may be considered an improvement.

## Disclosures

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

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