CHAPTER 7

Tax Benefits of Home Ownership

Pages 233-268

Land Grant University
Tax Education Foundation

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TAX BENEFITS OF HOME OWNERSHIP

- Issue 1: State and Local Property tax Deduction
- Issue 2: Home Mortgage Interest Deduction
- Issue 3: Home Office Deduction
- Issue 4: Exclusion of Gain on Sale of a Principal Residence
- Issue 5: Exclusion for Qualified Principal Residence Indebtedness
- Issue 6: Principal Residence in a Disaster Area

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ISSUE 1: STATE AND LOCAL PROPERTY TAXAX

- Tax Cut and Jobs Act (TCJA) of 2017 limited state and local property tax deduction (SALT) to $10,000 for MFJ
- One Big Beautiful Bill Act (OBBBA) of 2025 increases the limitation to $40,000 through 2029
- This limitation applies to state and local real estate taxes, personal property taxes, special assessments and sales tax

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DIVISION OF REAL ESTATE TAXES

- Must be divided between buyer and seller
- Prorated based on the date of sale
- Seller pays up to but not including the closing date
- Generally, the closing statement will break it down

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EXAMPLE 7.1

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- Property sold May 8, 2025
- Property taxes $6200 for 2025
- Billed December 1, due February 1
- 127 ÷ 365 x 6200 = $2157
- Example 7.2 – Delinquent taxes – buyer adds to cost of property, seller includes in sales price, but can deduct taxes paid by buyer

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TAXES FOR LOCAL BENEFITS

- Assessments for local benefits are not included in deductible property taxes, but increase basis
- Examples:
  - Sidewalks
  - Water mains
  - Sewer lines
  - Parking facilities

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ITEMIZED CHARGES FOR SERVICES

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Not included in Real Estate taxes

Itemized charge against specific people:

- Unit fee for delivery – water
- Unit fee for trash collection
- Flat fee for lawn mowing or snowplowing

Includible in Real Estate taxes

Fees charged across the board:

- Trash collection
- Recycling collection
- Funds that are not earmarked

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ISSUE 2: MORTGAGE INTEREST DEDUCTION

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- Higher interest rates may cause itemized deductions to exceed standard deduction ($30,000 for MFJ and $15,000 for MFS for 2025)
- IRC §163 allows a deduction for *qualified residence interest*
- Defined as interest paid or accrued on the acquisition indebtedness of a qualified personal residence

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ACQUISITION INDEBTEDNESS

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- Debt incurred for acquiring, constructing, or substantially improving the qualified residence of the taxpayer, and is secured by the residence
- Prior to 2018 and after 2025, cannot exceed $1,000,000 for MFJ
- Prior to 2018 and after 2025, home equity indebtedness cannot exceed $100,000 for MFJ

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ACQUISITION INDEBTEDNESS

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- 2018 to 2025 TCJA limited it to $750,000 for MFJ $375,000 for MFS
  - ✓ These limits don't apply to debt incurred before 12-15-17 or if TP entered into a binding contract before that date to purchase a residence before 1-1-18
- These limits apply to loan amounts to buy, build or substantially improve a primary or second home

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QUALIFIED PERSONAL RESIDENCE

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- Qualified residence means principal residence and one other residence
- Residence includes house, condo, mobile home, boat or house trailer that contains sleeping space, toilet, and cooking facilities
- Second residence that is used by the taxpayer as a residence not withstanding 280A(d)(1) personal use is the greater of 14 days or 10% of the rental days

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MARRIED PERSONS

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- If filing a joint return, property can be owned jointly or by only one spouse
- If filing separately, each can take one residence unless both consent in writing to one spouse claiming both

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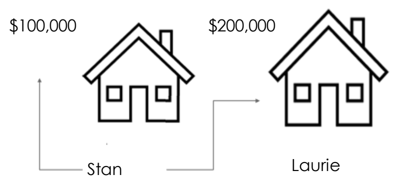
EXAMPLE 7.3



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ESTATES AND TRUSTS

Interest paid or accrued by estate or trust:

- Residence is qualified residence of beneficiary
- Beneficiary has a present interest in the estate or trust or a residual interest in the estate or trust

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SECURED DEBT

1. Property is security for the payment of the debt
2. Residence could be subject to satisfaction of the debt
3. Recorded or perfected in accordance with state law

Not considered secure if subject to a lien on the general assets of the taxpayer

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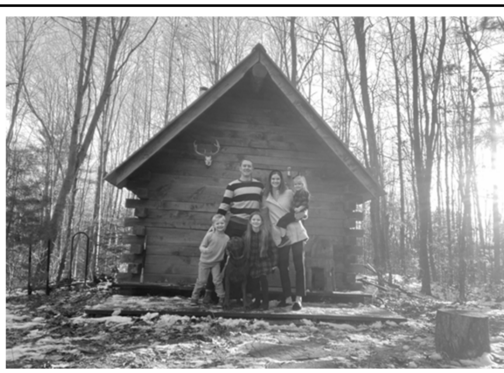

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THIRD PARTY LOAN

P 241

Factors to consider:

1. Right to possession
2. Responsibility for maintaining the property
3. Responsibility for insuring property
4. Who bears risk of loss?
5. Who is responsible for taxes and assessments?
6. Who can make improvements to the property?
7. Can third party obtain title by paying balance?

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EXAMPLE 7.4

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- Jessie and Lisa are siblings
- Lisa and her fiancé purchase a $300,000 house then split
- Jessie and Lisa agree that Jesse pay the remaining mortgage payments in exchange for a 50% interest in the house
- Jessie makes the mortgage payments, insurance and taxes
- Even though he is not on the mortgage Jesse can deduct the mortgage interest

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AVERAGE MORTGAGE BALANCE

- Mortgage interest is reported on Form 1098
- Box 2 on Form 1098 shows outstanding principal as of Jan 1
- Average balance can be used to calculate the deduction using 1 of 2 methods:
  1. Average first and last balance
  2. Interest paid divided by interest rate method

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AVERAGE OF FIRST AND LAST BALANCE

First of year balance + Last of year balance ÷ 2

This method can be used if:

1. The taxpayer did not borrow any new amounts
2. Did not prepay more than 1 month's principal
3. Made equal payments at fixed intervals at least semiannually

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EXAMPLE 7.5

- Jacqueline Monet (MFS) purchased residence for $531,250 on 1-1-25
- Loan for 425,000
- 4718.37 monthly payments with 6% interest
- End of the year balance $393,009.30

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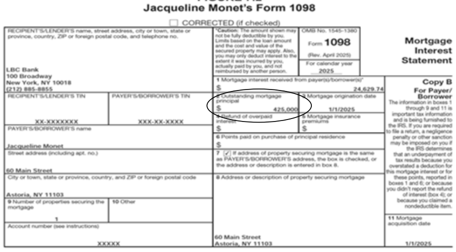
EXAMPLE 7.5

FIGURE 7.2
Jacqueline Monet's Form 1098


☐ CORRECTED (if checked)

RECIPIENT'S/LENDER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.
LBC Bank
100 Broadway
New York, NY 10018
(212) 885-8855

*Caution: The amount shown may not be fully deductible by you. Limits based on the loan amount and the cost and value of the secured property may apply. Also, you may only deduct interest to the extent it was incurred by you, actually paid by you, and not reimbursed by another person.

OMB No. 1545-1380
Form 1098
(Rev. April 2025)
For calendar year 2025

Mortgage Interest Statement

1 Mortgage interest received from payer(s)/borrower(s)* $ 24,629.74

RECIPIENT'S/LENDER'S TIN XX-XXXXXXX
PAYER'S/BORROWER'S TIN XXX-XX-XXXX

2 Outstanding mortgage principal $ 425,000
3 Mortgage origination date 1/1/2025
4 Refund of overpaid interest $
5 Mortgage insurance premiums $
6 Points paid on purchase of principal residence $

PAYER'S/BORROWER'S name
Jacqueline Monet

Street address (including apt. no.)
60 Main Street

7 ☑ If address of property securing mortgage is the same as PAYER'S/BORROWER'S address, the box is checked, or the address or description is entered in box 8.

City or town, state or province, country, and ZIP or foreign postal code
Astoria, NY 11103

8 Address or description of property securing mortgage
60 Main Street
Astoria, NY 11103

9 Number of properties securing the mortgage 1
10 Other

Account number (see instructions) XXXXX

Copy B For Payer/Borrower
The information in boxes 1 through 9 and 11 is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if the IRS determines that an underpayment of tax results because you overstated a deduction for this mortgage interest or for these points, reported in boxes 1 and 6; or because you didn't report the refund of interest (box 4); or because you claimed a nondeductible item.

11 Mortgage acquisition date 1/1/2025

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EXAMPLE 7.5

Using the loan balance from the 1098:

$375,000 ÷ 425,000 = .882

.882 x 24,630 = $21,724 Home mortgage interest deduction

Using first and last balance method:

$425,000 + 393,009 = 818,009 ÷ 2 = 409,005

375,000 ÷ 409,005 = .917

.917 x 24,360 = $22,586 Home mortgage interest deduction

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INTEREST PAID ÷ INTEREST RATE

Can use this method if:

1. Mortgage is secured by home
2. Paid interest at least monthly

EXAMPLE 7.6

Interest paid $24,630 ÷ 6% interest = 410,500

$375,000 ÷ 410,500 = .914

.914 x 24,630 = 22,511.82 Deductible interest

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POINTS

- Points are charges by a borrower to obtain a mortgage
- They are currently deductible if:
  1. Loan is secured by main home
  2. Paying points is an established practice
  3. Not more than generally charged
  4. Taxpayer uses cash method
  5. Not a substitute for normal charges
  6. Funds used to pay points are not borrowed
  7. Used to buy or build the main home
  8. Calculated as a % of the mortgage
  9. Clearly shown on settlement as points

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NON-DEDUCTIBLE AMOUNTS

- Appraisal fees
- Notary fees
- Preparation costs
- Mortgage insurance premiums

These are not deducted currently or over the life of the loan

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THINGS TO WATCH OUT FOR:

- Loan balance exceeds the applicable limits
- Mixed- use loan
- Interest paid is not reported – land contract situation
- More than one borrower – attach a statement to the return

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ISSUE 3: HOME OFFICE DEDUCTION

Qualifying for the deduction

- Exclusive Use Test – Must be specifically designated area used only for a trade or business
  - Exceptions – Daycare and inventory
- Function Test – Must meet one of the following:
  1. Principal place of the taxpayer's trade or business
  2. Used to meet with patients, clients or customers
  3. A separate structure is used

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EXAMPLE 7.7

- Mary Pruitt is a plumber
- She travels to her customers to provide plumbing services
- She had a room in her home that she uses regularly and exclusively for scheduling and billing

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HOME OFFICE DEDUCTION FOR EMPLOYEES

- Must be for the convenience of the employer
- Now that the miscellaneous itemized deductions are permanently eliminated this is no longer available

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CALCULATING THE DEDUCTION

Actual Expense Method – Use Form 8829

1. Calculate the income from the business w/o home office
2. Allocate the itemized deductions to the portion of the home used as home office (interest and real estate taxes)
3. Allocate other operating expenses (utilities, maintenance, and insurance)
4. Calculate deductions that decrease basis such as depreciation and casualty losses

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EXCESS REAL ESTATE TAXES & MORTGAGE INTEREST

- The taxpayer may be limited to the amount they can deduct for real estate taxes (now $40,000 for 2025) and for mortgage interest due to limitation of qualified indebtedness.
- Because of these limitations the taxpayer may not be able to deduct the full amounts paid

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LIMITATION ON DEDUCTION

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If business has a loss, expenses are limited. Ordinarily nondeductible expenses are limited (insurance, utilities)

1. Business part of expenses taxpayer could deduct even if the home were not used for business (interest and property taxes)
2. Business expenses that relate directly to the business such as business phone and office supplies

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EXAMPLE 7.10

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FIGURE 7.7
Georgia Baker's Business Expenses and Expenses for Business Use of Her Hom

	Gross income from business	$6,000
Step 1	Direct business expenses not related to use of the home (business phone, supplies, and depreciation on equipment) ($2,000 × 100%)	(2,000)
Step 2	Deductible mortgage interest and real estate taxes ($15,000 × 20%)	(3,000)
	Remaining net income after steps 1 and 2	$1,000
Step 3	Maintenance, insurance, and utilities allocable to business use of home ($4,000 × 20%)	(800)
	Remaining net income after steps 1, 2, and 3	$ 200
Step 4	Depreciation ($8,000 × 20%), limited to $200 remaining net income	(200)
	Taxable business income	$ 0
	Depreciation carryover ($1,600 − $200)	$1,400

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SIMPLIFIED METHOD

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- Multiply $5 by the qualified business square footages, limited to 300 square feet
- Maximum deduction $1500
- Subject to the gross income limitation
- Make the election for that year by using the simplified method – irrevocable election for the year used
- Can still deduct home mortgage interest and property taxes on Schedule A.

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ADDITIONAL TIDBITS

- Taxpayers can switch from one method to another from year to year
- Depreciation for years using the simplified method is determined to be zero
- Calculate average monthly square footage
  1. Home office is not used for the entire year
  2. Size changes
  3. When using simplified method must be used at least 15 days and no more than 300 square feet

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ADDITIONAL TIDBITS

- Taxpayers sharing a home may each take up to 300 square feet
- Taxpayers that have more than one business and use the simplified method are limited to 300 sq ft for all businesses combined even if they have more than one home, but can use actual method

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SALE OF RESIDENCE WITH HOME OFFICE

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- When depreciation is allowed or allowable for a home office and the taxpayer later sells for a gain, some of the gain is taxable even if otherwise excludable
- See Figure 7.9 page 256

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ISSUE 4: EXCLUSION OF GAIN ON THE SALE OF PERSONAL RESIDENCE

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- IRC §121 provides for the exclusion of the gain on the sale of the personal residence
- Maximum exclusion is $500,000 for MFJ
- Three requirements must be met:

1. Own property for 2 or more of previous 5 years (1spouse)
2. Use the home as principal residence for 2 of 5 years (both)
3. 2 years since last sale for which exclusion was used (neither)

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PRACTITIONER NOTES

- Homes owned by partnerships, multimember LLCs, and corporations do not meet the ownership requirements, but single member LLCs, housing cooperatives and grantor trusts may qualify
- The 5-year test may be suspended from members of the uniformed services and Peace Corp employees who serve overseas

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USE AS A PRINCIPAL RESIDENCE

Ordinarily where TP spends most of their time

Factors considered:

1. Place of employment
2. Principal place of abode of family members
3. Address listed on documents
4. Mailing address for bills
5. Location of banks
6. Location of religious organizations and clubs

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SALE OF ADJACENT LAND

- Vacant land used as part of the principal residence qualifies for the exclusion if the principal residence is sold within 2 years of the sale of the land
- Land sale must meet §121 requirements

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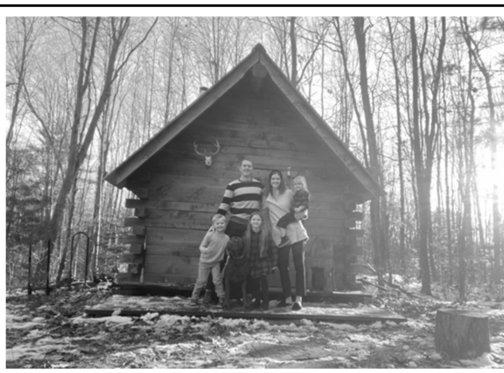

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EXCEPTIONS TO THE 2-YEAR TEST

P 258 - 259

Work-related move

- Occurs during the time home owned and occupied
- New job 50 miles farther from home than old job

Health-related move

- Physician recommends the move

Unforeseeable Events

- Involuntary conversion
- Natural or manmade disaster
- Death, loss of employment, divorce, multiple births

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CALCULATING THE REDUCED EXCLUSION AMOUNT

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Maximum Exclusion x

The least of:
1. Time that TP owned property
2. Time that TP used as primary residence
3. Time between prior sale and current sale

730 days or 24 months

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EXAMPLE 7.19

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Gerald and Emily Haven

Move due to change in employment

Purchased home	10-1-24	$200,000
Sold home	8-1-25	260,000
Gain on sale		60,000

Exclusion amount = 500,000 x (10 months ÷ 24 months) = $208,333

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SALE OF HOME BY SURVIVING SPOUSE

If taxpayer's spouse dies before the sale of home, surviving spouse can still exclude $500,000 if:

1. Sale no later than 2 years following spouse's death
2. At the time of death all the requirements were met
3. Surviving spouse did not remarry before the sale

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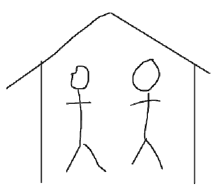
UNMARRIED CO-OWNERS

- Must keep track of expenses of cost and improvements separately and the gain and exclusion amounts are calculated separately



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CONVERTING RENTAL PROPERTY TO PERSONAL RESIDENCE

- No exclusion for depreciation allowed or allowable
- No exclusion of gain for periods of nonqualified use
- Period of nonqualified use does not include the following:

1. 5-year period immediately preceding sale used as principal residence
2. Period during which TP is serving on qualified official duty
3. Temporary absence due to change of employment, health condition or unforeseen circumstances.

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EXAMPLE 7.24

P 263 -264

FIGURE 7.11
Ken Yamazaki's Gain on Sale of Former Vacation Rental Home

Sale price	$375,000
Cost basis before depreciation	(250,000)
Total gain for proration	$125,000
Gain eligible for exclusion [(6 ÷ 11 years) × $125,000]	(68,182)
Gain allocable to nonqualified use	$56,818
Accumulated depreciation	18,000
Total reportable gain	$74,818

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ISSUE 5: EXCLUSION FOR QUALIFIED PRINCIPAL RESIDENCE INDEBTEDNESS

P 268

- Cancellation of Debt (COD) income is the difference in the amount owed and the amount accepted in satisfaction of that debt
- Cancellation of debt income is generally taxable unless otherwise excludable
- IRC §108(a)(1)(E) provides an exclusion for personal residence indebtedness discharged before January 1, 2026
- Maximum amount that can be excluded in $2M

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ISSUE 6: PRINCIPAL RESIDENCE IN A DISASTER AREA

P 267

<u>Personal Property</u>

- Payments from insurance for <u>unscheduled</u> personal property is not recognized as gain
- All other payments the TP can defer the gain by replacing

<u>Home</u>

- Can defer the gain from the insurance proceeds by replacing within 2 years
- If federally declared disaster area – 4 years

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EXAMPLE 7.27

- Larry and Winona Hill's home destroyed by flood in 2025
- $200,000 for the home, 25,000 for unscheduled personal property, 5,000 for jewelry, and 10,000 stamp collection
- No gain recognized on the 25,000
- If reinvest the remaining $215,000 within 4 years, deferred gain

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TEMPORARY LIVING EXPENSES

P 267 -268

- If a home cannot be occupied following a casualty, insurance reimbursement for temporary living expenses can be excluded
- Exclusion amount = actual temporary living expenses – normal living expenses
- Living expenses include rent, meals, utilities, transportation…
- TP may need to make the allocation

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P 268

POSTPONED TAX DEADLINES

- Taxpayers may be eligible for 60 day postponement for paying or filing tax, making IRA contributions
- Qualifications:

1. Residence in disaster area
2. Principal place of business in disaster area
3. Working with recognized organization in disaster area
4. Records are in the disaster area
5. Killed or injured in disaster area
6. Spouse of someone in 1-5

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