CHAPTER NINE

DEATH AND TAXES

How Home Ownership Affects Your Tax Bill

“BUT IN THIS WORLD nothing is certain but death and taxes," wrote Ben Franklin in 1789. But just as good health and medicine can help you postpone death, good advice and record keeping can help you reduce some taxes and postpone others.

That's especially true for you, the owner of that special place where you put your feet up. In the words of the late Sylvia Porter, personal finance guru, "Uncle Sam loves a home owner." It's our national policy that home ownership is good for the country, so (in a rare show of consistency) federal tax laws encourage people to buy and keep their own homes. This chapter will point out some of the tax breaks that may be available to you as a homeowner. It's no great surprise, though, that what the government gives with one hand, it takes away with the other. Homeowners may get breaks on their income taxes, but they have to ante up for state and local property taxes. Fortunately, some localities provide property tax relief for particular types of homeowners such as farmers or owner-occupants, and almost all states equalize the tax burden by requiring local governments to maintain the same level of assessment for everyone. Still, assessors do make errors. The final section of this chapter will explain the assessment process and what steps you can take if your tax bill seems unreasonably high.

INCOME TAX DEDUCTIONS

Let's begin, though, with federal income taxes. Numerous deductions are available for the homeowner, some more significant than others. As you know, a deduction is an amount of money you subtract from your taxable income, thereby lowering the amount you have to pay. The federal government allows certain deductions in hopes of advancing particular social goals such as allowing people to provide for their children. In your case, the social goal is encouraging home ownership.

While the easiest way to do your taxes is just to claim the standard deduction, the only way to take advantage of the tax breaks described below is to itemize. That means more work and more careful record keeping, but it's time well spent because of the significance of the tax savings.

Here are some deductions that may be available to you. Remember that tax law is constantly changing, so don't rely on outdated IRS publications. The latest publications are available free from your local IRS office, or you can call 1-800-TAX-FORM (1-800-829-3676). Or check the IRS website at www.irs.gov.

Property Taxes

The good news about having to pay state and local property taxes is that you can deduct them on your federal tax return. Keep track of what you pay (whether directly or through your mortgage lender's escrow account) and enter it in the appropriate place on your income tax form. Water and sewer charges, which generally are not measured by the value of the affected property, are not deductible.

Mortgage Interest

The biggest break for homeowners is that you can deduct all the interest paid on a mortgage loan incurred to buy, build or improve your home, up to $1 million. That's especially helpful in the first few years of your mortgage, when nearly every dollar of every mortgage payment you make goes to interest, not principal. Since many people put a quarter to a third of their incomes into mortgage payments, having such a big percentage be essentially tax-free is good news indeed

Mortgage interest on a second home is also deductible. If you own more than two (dream on!) you may only claim one of them as your secondary residence in any given year. It’s okay to change from year to year which secondary residence you claim the mortgage interest on, but not to claim one as your secondary residence for half of the year and the other for the other half.

If you increase your mortgage when you refinance your home, interest on the increase is not deductible unless the increase qualifies as a home equity loan or you use the extra proceeds for home improvements.

Loan Origination Fees

If your mortgage deal required you to pay loan origination fees, better known as points, those fees are because they're essentially interest paid in advance. However, if the loan isn't to buy or improve your principle residence, you have to spread the deduction over the life of the loan rather than take it all on the first year's tax return. Points are deductible when you refinance, but again the deduction must be spread over the entire term of the loan. If you later refinance again, though, you can probably deduct the remaining portion of the points from the prior refinance. The rules here are complicated, so talk to a tax professional or IRS representative about your particular circumstances

Interest on Home Equity Loans

If you take out a home-equity loan of up to $100,000, you can deduct the interest no matter what you do with the money. The total debt, though, may not exceed the fair market value of your home.

Rental Units

What if you rent out your basement apartment or the other half of your duplex? Rules for business property apply to that portion of your home, allowing you to deduct fire insurance premiums, utilities, repairs, depreciation and similar expenses as well as mortgage interest and property taxes. Those expenses have to be written off over several years on a depreciation schedule. Consult IRS Publication 527, "Residential Rental Property," for details.

Vacation Home Expenses

People often offset the cost of their resort condo or lakeside cabin by renting it out part of the year. Accordingly, tax law treats a vacation home as a hybrid of a residence and a business property. Which expenses are deductible depends on how many weeks per year it's used by you or your relatives, and how many weeks it's rented out.

Suppose you rent it less than 15 days per year. You don't have to report rental income, but you can only deduct mortgage interest, property taxes and casualty losses (see below). At the other end of the spectrum, suppose you or your family don't use it more than 14 days (or 10 percent of the days it was occupied). In that case, while you'd have to report rental income, essentially all the expenses of maintaining the property are deductible. The IRS recognizes a couple of categories in between with corresponding rules; consult IRS Publication 527 for details.

Leased Land

If you own a home that stands on leased ground, you may be able to deduct the rent you pay for the land. The Internal Revenue Code generally allows ground-rent deductions for leases of 15 years or more that include an option to buy the land. When you buy the land, though, your payments aren't tax deductible.

Casualty Losses

If your home is damaged by a natural disaster such as fire, flood or tornado, and the loss isn't fully covered by insurance, your out-of-pocket expenses may qualify as a deductible casualty loss. The same goes if a burglar breaks in and steals your uninsured diamond ring. Note that casualty losses are one-time occurrences; sustained damage by termites or slowly leaking pipes doesn't count. It’s up to you to prove that the disaster occurred, so collect newspaper clippings, police reports and insurance reports.

You have to take the deduction in the year the loss occurred unless your home is in a national disaster area, where records may have been lost. In that case, you can amend the previous year's return to claim the deduction.

Any insurance reimbursements or federal disaster relief grants are subtracted from the casualty loss, along with a $100 deductible. Then you multiply your household's adjusted gross income by 10 percent; only casualty losses exceeding that figure can be deducted.

You may not be able to deduct much casualty loss if your home wasn't worth much to begin with. Deductible losses are limited to the difference between the home's market value right before the damage and its market value right after, as determined by an appraiser. If the home's adjusted basis (its original cost plus improvements) is even less than the market-value calculation, the adjusted basis serves as the limit for deductible casualty losses. For more on a home's basis, see the next section.

Likewise, note that casualty losses are among the itemized deductions that are only deductible to the extent that they exceed two percent of your income.

Home Office

If you run a business from your home, or work there for your employer’s convenience, your office expenses are probably deductible. Depending on the size of your home and how much of it is designated office, the deduction can be significant enough to justify the extra effort needed to qualify. If your office meets the standards spelled out by the IRS, you can deduct the cost of repairs, furniture, computers and office equipment, extra telephone lines and other business-related expenses. You can also deduct a proportional share of your home's **depreciation** (ordinary wear and tear), utility bills and insurance. Be aware, though, that you can deduct no more than your business actually generated.

Although you can no longer deduct the entire cost of a desk or computer the first year, you may claim **accelerated depreciation** if you use the item more than 50 percent of the time for your job. This allows you to claim most of the deduction the first two years.

The IRS, however, reserves the right to declare that your "business" is really a hobby, or that your home office doesn't meet its rather stringent standards for deductible business use of the home. For more on IRS standards in this area, see sidebar, "Your Home Office."

Historic Homes

If your home is listed on the National Register of Historic Places or stands in a historic district, you might be able to deduct some of the costs of rehabilitating your home--but only if you rent part of it out. Otherwise, the IRS considers your rehab costs to be personal expenses, not business ones.

If you grant a facade easement to a historic preservation association, restricting yourself and all future owners from changing your home's facade, you may be able to deduct any loss in the home's market value as a charitable deduction. Figuring out how your home might be more valuable if its facade were changed is a bit speculative, though; better get professional help.

WHEN YOU SELL

Most year-to-year deductions are small potatoes compared to the biggest tax liability homeowners used to face: tax on their capital gain when they sell the house. Normally, any time you sell property for more than you paid for it, whether it's a stock portfolio or the family bungalow, Uncle Sam wants a slice of the pie. Since a house purchased for $40,000 in the 1950s might be worth $400,000 or more today, the income tax on that much gain could be staggering. Fortunately, the federal government provides some protection for those pursuing the American dream of moving up, and for golden agers who want to sell the family home and live off the proceeds.

"Basis" and Other Basics

First, though, be sure you understand how the government computes capital gain. The key concept is your home's **basis.** This is the price you paid for the house back when you bought it, or, if you inherited it, what it was appraised for at that time. If you built your home, it's the cost of the land at the time plus all costs of construction. The basis is increased by certain types of home improvements. Likewise, the basis is decreased by uninsured casualty losses, such as the garage being washed away by a flood.

The higher your basis, the smaller your gain, which is the difference is between your basis and what you sell the house for. The smaller the gain, the less tax you have to pay. So it's a good idea to keep track of improvements that might increase your home's basis. These are alterations that either increase its value, extend its life or alter its uses, such as adding a bathroom, landscaping the yard, building in bookcases, wallpapering the bedrooms or even putting brass numbers by the front door. Pay for such work by check, get a receipt and keep it in a file where you can use it later to prove that your home's basis has increased. Note that mere repairs, such as fixing leaky pipes or reshingling the roof, don't count. But if you package a bunch of repairs and call it an "extensive remodeling or restoration," the IRS is willing to adjust your basis upward.

While a routine paint or plaster repair job wouldn't normally affect your basis, fix-up costs that you incur within 90 days of signing a contract for sale can be figured in when you're calculating the profit on the sale. So can real estate commissions, attorney's fees, title insurance, local transfer taxes and other costs of selling. So while long-term home improvements serve to increase the home's basis, fix-up costs reduce your profit on the sale and accordingly reduce your tax liability.

Avoiding Capital Gain

Now, about those protections. Until May 7, 1997, homeowners who sold their house could defer payment of capital gains tax by rolling the proceeds of the sale into a new house--but only if the new house cost more than the old one did. Then, after age 55, when they were probably in a lower tax bracket and ready for a smaller home or retirement community, each person was entitled to exclude up to $125,000 in profit--but only once. Because of these rules, many families bought bigger, more expensive houses than they needed, especially if they moved to an area with lower real estate values.

All this changed in 1997 with a new tax law. Now, you don’t have to pay capital gain on the sale of any residence you’ve lived in for at least two of the last five years, unless the profit is more than $250,000 per person or $500,000 per couple. You have to count not only the profit on this house but on any other houses you sheltered by rollover prior to 1997. If special circumstances meant you had to move before living there two years, you can exclude part of the profit--for instance, half the profit if you lived there only one year, up to your $250,000 limit.

This change means that most people won't have to pay capital gains taxes at all on their home, unless they've racked up enormous profit. And you can exclude capital gain on sale of your residence as many times as you wish. One couple in California builds their own houses, lives in each one two years, and sells them for a substantial profit, all tax free. Note that this door doesn't swing both ways. If you lose money on the sale of your home, you can't deduct the loss and pay less in taxes

The capital gains exclusion doesn't apply to investment properties and vacation homes. However, people with more than one home can avoid tax on each of them with a little planning. For instance, if you have a condo in New York City and a house in Florida, you could make the New York home your primary residence for two years before selling it, then make the one on Florida your primary residence for two years before selling it. For a house to count as your primary residence, you have to live there for 183 days each year.

Win or lose, whenever you sell a home you have to file Form 2119, reporting the sale date, the price and how much profit is subject to immediate taxation, if any. This one-page form takes you through the calculations required to determine gain on sale, adjusted sales price, taxable gain, and the adjusted basis of your new home. If your new home costs less than the adjusted sales price of your old home, you might have to pay some tax now while deferring the rest. If you die without selling the home, all capital gains taxes are wiped off the slate. Your beneficiaries will inherit it at a new, stepped-up basis, and they don't have to pay any tax on capital gains accumulated on the sale of your home or homes over the years.

What if you own a duplex, live in one unit and rent out the other? In that case, you can only avoid capital gain on the half you use as your residence. The other is a business property, not subject to this tax break.

Save your receipts, because eventually your house just might gain enough in value that you'll want to prove that your basis has increased and therefore the profit isn't as great as it appears.

For details on IRS regulations in this area, see Publication 523, "Selling Your Home."

PROPERTY TAXES

Our country had property taxes before it was a country; the Massachusetts Bay Colony levied a tax to pay government expenses back in 1692. In every state in the union, property taxes provide much of the revenue used for schools, police protection, fire fighting and other services. In 47 states, responsibility for assessment and administration of property taxes is shared between state and local governments (in Maryland it's all done at the state level, while Delaware and Hawaii rely entirely on local efforts).

While citizens disagree strongly on how much taxation is needed to pay for needed services, most would agree that the system should be fair, requiring owners of similar properties to pay similar tax levies. The collection of property taxes involves a complex process of assessment, though, and mistakes can be made. It's important to understand how the system works and what you can do if your tax bill seems to be out of line.

The Assessment Process

In most states it's up to the assessor or board of assessors, who are local government officials, to place a value on your property for tax purposes. Generally they follow a locally accepted formula for assigning value. The local government then imposes a certain amount of tax per dollar of assessed value, which results in the tax bill you receive in the mail.

The process of arriving at individual property tax bills is rather complex. Each property in the municipality is described on a "property record card," which includes a legal description of the land and a description of the buildings and other improvements on the land, which probably indicates square footage, construction materials, depreciation and other physical attributes. It may include a recent sale price or the assessor's estimate of the value of the improvements based on replacement cost. If the owner has taken out a building permit for a big addition, that might be noted on the card too. Each property is reassessed on a regular basis, whether every year or every four years.

In big metropolitan areas, there are simply too many homes to assess each one based on its individual characteristics. Instead, the assessor might use a mass appraisal method, assigning a value per square foot for a given neighborhood.

There's usually a complicated schedule for getting from appraised value to the dollar amount of taxes owed. In many states the actual value is reduced by a certain percentage, then multiplied by the local millage rate. (Millage is a common method for determining property tax. A mill is one one-thousandth of a dollar. So your town taxes eight mills and you property is valued for tax purposes at $100,000, you'd owe $800.) After crunching all the numbers, city employees send you a notice of assessed value, followed before long by the actual tax bill. The Internet may help you here. If your county assessor has a web page, you may be able to compare the assessed value of your neighbors' homes and comparable homes in the area. If your assessment looks reasonable, you pay the bill and that's the end of it.

Fighting City Hall

But what if you think the tax levy is out of line? What if the assessment has jumped dramatically since last year? Or what if property values in your neighborhood have plummeted but the assessment hasn't?

The time to object is when you receive notice of assessed value. Most likely you have a given time period to object and try to convince the assessors to change their minds. If you wait to receive the actual tax bill, it may be too late.

At this stage, procedures are informal. You may want a lawyer to help you set up the best case, but many homeowners represent themselves. Your job is to gather any evidence you think will show that your property isn't worth as much as the assessor thinks it is, and to present your argument in a clear, rational manner.

Here's what you might want to look at:

- **Assessment notice**. Look for obvious mistakes in the notice you received, such as an incorrect address or the wrong number of bedrooms.
- **Property record card**. If your county assessor has the information posted on the Internet, check the record on your property. Otherwise, go down to the assessor's office and ask to see your property record card or a printout of the computer record. Make sure the acreage, square footage and other details are correct.
- **Special tax breaks**. Some jurisdictions give tax breaks to certain categories of property owners such as a 10 percent tax waiver for owner-occupied homes or for disabled veterans. Ask the assessor's office what breaks you qualify for and make sure that exemption is reflected in the assessment notice. Tax breaks aren't given automatically; you have to apply for them.
- **Purchase contracts** and closing statements showing that the house changed hands recently at a lower price than the assessed value.
- **Property condition**. Is your home overrun by termites or badly damaged by fire? The assessor might not know about it. Take repair estimates or photos with you to show that your house isn't

worth what they say it is.

- **Comparable homes**. Do a bit of research to learn what similar homes in your neighborhood have sold for recently. If you can’t find it on the Internet, local real estate brokers should have sales information, or check with the county registrar of deeds. You can even ask at the assessor's office to see the assessed value of comparable homes. Be sure you have the address of each house you talk about, and if possible the permanent index number (available from the county collector's office or the township assessor).
- **Appraisal**. If the amount in dispute is significant enough and you're pretty sure you're right, you may want to hire an appraiser to provide a second opinion on the value of the property. When choosing an appraiser, look for someone well qualified, with a reputation for competence, who would be credible as a witness.

If your negotiations with the assessor don't go your way, you may be able to appeal the decision through an equalization board, assessment review board or board of appeals. Some jurisdictions have a taxpayer's advocate to take your side and help you through the process. Again, you'd present your evidence and explain why you believe your assessment should be lowered.

If that doesn't work and you really want to push it further, the next step would be taking it to a state court or tax tribunal. Consult your lawyer or local government officials to find out what your options are and how to proceed.

If you engage a lawyer to argue your case before the assessor or the review board, you'll probably have to pay a percentage of your tax savings in legal fees. If you win, though, you could save several hundred dollars per year.

YOUR HOME OFFICE

So you've started a home-based business, selling wallpaper supplies or writing brochures for local merchants. You turn the spare bedroom into an office. Can you deduct office costs as a business expense?

Yes, if you meet the following tests:

- Your business has to generate a profit at least two out of five years. Otherwise, the IRS may consider it a hobby, not a business.
- Your home has to be the principal place of business for the operation, which means (under new rules effective in 1998), that (1) you use the office to conduct administrative or management activities for the business and (2) there is no other fixed location for these activities. The space must be used regularly as an office. Part-time work is fine, as long as it's regular.
- The office must be used exclusively for the business. The IRS frowns on claims that it’s an office if it's also the family TV room. One exception is home day care, which often takes place in rooms the family uses during off hours. In that case, you figure what percentage of the time it's used for day care purposes and deduct that percentage of the expenses for those rooms.
- If you work as an employee, your working at home must be for the convenience of your employer. For more information, consult IRS Publication 587, "Business Use of Your Home."

TAXING THE HOUSEKEEPER

In the early days of the Clinton Administration, a nominee to the office of attorney general was forced to withdraw because she had failed to pay employment taxes for her child's nanny. Whether or not you're a candidate for public office, you could get in trouble with the IRS for failing to pay Social Security and Medicare taxes for people who work in your house, whether you hire a full staff of gardeners, butlers and maids or just a housekeeper who comes in for a few hours a week.

The regulations are stricter than you might expect. The IRS considers you an employer if a worker performs services that are subject to your will and control as to what must be done and how to do it. A lawn-care service that provides its own tools and laborers would not be the homeowner's employee, but a once-a-week housekeeper subject to the homeowner's supervision would be.

However, in 1994 Congress changed the law to ease the filing requirements for those who employ domestic workers. In 1994, you were required to pay Social Security taxes to the IRS for every employee who made more that $1,000 a year (the amount will be adjusted annually for inflation). However, no taxes are owed for domestic employees under the age of eighteen whose primary occupation is not domestic work.

Failing to do all this could lead to fines. The IRS can't necessarily tell who hires a housekeeper and who doesn't, but certain inconsistencies serve as red flags. For instance, if you claim a deduction for in-home child care but neglect to pay employment taxes on your nanny, you might be in hot water. Ditto if you include the cost of a housekeeper in your home office deductions but fail to withhold.

IRS Publication 926, "Employment Taxes for Household Employees," tells how much to withhold and what to send where.

THE TAXPAYER'S BILL OF RIGHTS

Dealing with the IRS will never be a picnic, but since 1988 the prospect of an audit has been a little less daunting. The "Taxpayer's Bill of Rights" enacted that year gives taxpayers some leverage in disputes with the IRS.

Part of the wide-ranging Technical Corrections and Miscellaneous Revenue Act of 1988, the bill came about when legislators heard one too many tales of woe from constituents penalized because they made an innocent mistake on their tax returns (the IRS vehemently opposed the bill and lost).

Here are some of the major provisions that may help you.

- If you make an error on your return because an agent at the IRS gave you incorrect advice, any penalties must be withdrawn. Unfortunately, this only applies to written advice, which the IRS is not required to give.
- Anytime the IRS writes you about uncollected taxes, it must now enclose a list of taxpayers' rights and the obligations of the IRS concerning audit, appeals, refund and collection.
- If the IRS wants to question you about your tax records, it must set a reasonable time and place. You can bring your attorney or accountant, and tape record the entire proceeding (at your expense).
- In the past, some field offices have evaluated their agents' performance based on how much tax

money they collect. Quota systems are now illegal, and field officials must file periodic statements that they do not use quotas.

- You now have a right to sue the IRS for damages if one of its agents, in the process of collecting taxes, recklessly or intentionally disregards the tax code.
- If you've entered an agreement with the IRS to pay your taxes over time, the agency cannot cancel the agreement without notice even if your finances have improved. They can cancel the agreement if you fail to make payments, but must follow procedures set out in the new law.
- Before seizing your bank account or other property to pay back taxes, the IRS must provide 30 days' notice rather than 10. The amount of wages and property exempt from levies, such as tools and equipment needed for the taxpayer's trade or business, has also been increased.

Congress is expected to pass the Taxpayer's Bill of Rights 2000, which protects taxpayers' privacy. The bill would require lenders who obtain federal tax forms from people applying for a loan to keep those forms confidential and not use them for any other purpose. This is in response to a common practice among lenders of transferring information from borrowers' tax returns into a database and selling it to outside marketers, private investigators, attorneys, insurance companies and others. The new law would require lenders to guarantee the confidentiality of taxpayer information and use it only for the purpose of evaluating the borrower's finances.

TAXING THE CONDO

If you live in a condominium or cooperative, here are some special tax considerations.

- The homeowners' association must file a tax return to report any income, such as interest income on the association's bank account. If the association has very little income, files annually as a tax-exempt organization and 90 percent of its expenses are for common element maintenance, the simple Form 1120 is enough. Otherwise, it has to file corporate Form 1120.
- If your condominium's common elements are upgraded, say with new windows throughout, your share of the expense can be added to your unit's cost basis for tax purposes. Such improvements add to the value of your unit, so they increase the basis (original cost plus improvements). That's good, because then you'll effectively have less profit when you sell the place, so will owe less tax on capital gain if you exceed your $250,000 limit. Save your association's annual report, which should list common element improvements and their cost per unit.
- Property taxes on condominium or cooperative units reflect the size of each unit and each unit owner's share of the common elements. As with a house, check your statement to make sure you've been assessed properly.

GAIN AND LOSS IN DIVORCE

If you think the rules on capital gain are complex, consider what happens when two homeowners go their separate ways. In case of divorce, each spouse bears half the adjusted basis of the marital home. There could be tax consequences if capital gains exceeded the $250,000 limit for each of them.

If you get divorced, work with an experienced attorney to make sure the issue of capital gain is addressed fairly. The divorce settlement agreement should provide that the spouses share equally in any tax on the gain.

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