

## THE TAX SHELTER OVER YOUR HEAD

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Home prices, which had been on a tear, have leveled out and even fallen in places. The housing “bubble” appears to be over. Is real estate still a good place for your money?

Despite uncertain real estate prices, buying a house is still a smart choice for most families. Buying, rather than renting, replaces nondeductible rent with deductible mortgage interest. You can borrow tax free against your home’s growing equity. And you can sell your home for up to \$500,000 profit, tax free.

#### Mortgage Interest

Tax-deductible mortgage interest is the cornerstone of most families’ tax planning. You can deduct interest on up to \$1 million of “acquisition indebtedness” you use to buy or substantially improve your primary residence, and one additional home. You can deduct interest on up to \$1 million of construction loans for 24 months from the start of construction. Interest before and after this period is nondeductible. And points you pay to buy or improve your primary residence are generally deductible the year you buy the home if paying points is an established practice in your area.

#### Home Equity Interest

You can deduct interest you pay on up to \$100,000 of home equity loans or lines of credit secured by your primary residence and one additional residence. Using home equity debt to pay off cars, colleges, and similar debts lets you convert nondeductible personal interest into deductible home equity interest.

Make sure you compare after-tax rates before you refinance consumer debt with home equity debt. If you can buy a car with a special interest

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rate, your nondeductible personal interest may still cost less than deductible home equity interest. If you can transfer a credit card balance to a new card with a low introductory rate, you could save money and avoid the paperwork needed to refinance your home.

If you pay points to refinance your home, you can't deduct those points immediately. However, you can amortize them over the life of the loan. If you pay off the loan before fully deducting your points (including refinancing with a *new* lender), deduct the remaining balance the year you retire the loan.

You can still deduct the interest you pay on home equity balances over \$100,000 if you use the proceeds for a deductible purpose. If you use home equity debt to buy stocks, for example, you can deduct it as investment interest; if you use it to finance your business, you can deduct it as a business expense.

### **Property Tax**

You can also deduct property taxes you pay on your primary residence and vacation homes. Microsoft founder Bill Gates can deduct over \$1,000,000 he pays on his Seattle-area compound. But be aware that property tax deductions may be limited by the Alternative Minimum Tax (AMT).

### **Tax-Free Income From Selling Your Home**

The Taxpayer Relief Act of 1997 made important changes that affect you when you sell your primary residence. The old law, effective for sales before May 5, 1997, let you roll unlimited gains into a new home and offered a one-time \$125,000 exclusion if you sold your home after age 55. The new law lets you exclude up to \$250,000 of gain (\$500,000 for joint filers) every two years, with no need to roll your gains into a new home.

You can exclude \$250,000 if:

- You owned the home for two of the last five years;
- You occupied it as your primary residence for two of the last five years;
- And you haven't used the exclusion within the last two years;

You and your spouse can exclude up to \$500,000 if:

- Either of you owned it for two of the last five years;
- Both of you used it as your primary residence for two of the last five years;
- And neither of you has used the exclusion within the last two years.

You can exclude part of your gain (calculated by dividing the number of months you qualify by 24) without meeting that two-year minimum, if your move is due to:

- Change in employment (you, your spouse, a co-owner of the house, or any other person whose principal abode is in the home accepts a job whose location is at least 50 miles farther from the home than their previous place of employment);
- Health (a qualifying person or their relative moves to treat a disease, illness, or injury, or to obtain or provide medical care for a qualified individual); or
- “Unforeseen circumstances” (including, but not limited to, involuntary conversion, natural or man-made disaster, or a qualifying individual’s death, unemployment, change in employment or self-employment status, divorce, or multiple births from the same pregnancy).

Taking advantage of the tax shelter over your head won’t guarantee gains. You have to consider how long you’ll own your home, the cost of maintaining and repairing it, and the eventual cost of selling it. But the “tax shelter over your head” is still likely to prove a long-term winner.

This is intended for general interest and not as specific legal or accounting advice for anyone. You should consult your tax advisor to get more information.