



Tax Benefits of Home Ownership

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In tax lingo, your principal residence is the place where you legally reside. It's typically the place where you spend most of your time, but several other factors are also relevant in determining your principal residence. Many of the tax benefits associated with home ownership apply mainly to your principal residence — different rules apply to second homes and investment properties. Here's what you need to know to make owning a home really pay off at tax time.

Deducting mortgage interest

One of the most important tax benefits that comes with owning a home is the fact that you may be able to deduct any mortgage interest that you pay. If you itemize deductions on Schedule A of your federal income tax return, you can generally deduct the interest that you pay on debt resulting from a loan used to buy, build or improve your home, provided that the loan is secured by

your home. In tax terms, this is referred to as “home acquisition debt.” You’re able to deduct home acquisition debt on a second home as well as your main home (note, however, that when it comes to second homes, special rules apply if you rent the home out for part of the year).

For mortgage debt incurred prior to December 16, 2017, up to \$1 million of home acquisition debt (\$500,000 if you’re married and file separately) qualifies for the interest deduction. If your mortgage loan exceeds \$1 million, some of the interest that you pay on the loan may not be deductible.

For mortgage debt incurred after December 15, 2017, up to \$750,000 of home acquisition debt (\$375,000 if you’re married and file separately) qualifies for the interest deduction. If your mortgage loan exceeds \$750,000, some of the interest that you pay on the loan may not be deductible.

A deduction is no longer allowed for interest on home equity indebtedness. Home equity used to substantially improve your home is not treated as home equity indebtedness and can still qualify for the interest deduction.

For more information, see IRS Publication 936.

Mortgage insurance

You can generally treat amounts you paid during 2021 for qualified mortgage insurance as home mortgage interest, provided that the insurance was associated with home acquisition debt, and was being paid on an insurance contract issued after 2006. Qualified mortgage insurance is mortgage insurance provided by the Department of Veterans Affairs, the Federal Housing Administration, the Rural Housing Service and qualified private mortgage insurance (PMI) providers. The deduction is phased out, though, if your adjusted gross income was more than \$100,000 (\$50,000 if married filing separately).

Starting in 2022, amounts paid for qualified mortgage insurance are generally not deductible.

Deducting real estate property taxes

If you itemize deductions on Schedule A, you can also generally deduct real estate taxes that you’ve paid on your property in the year that they’re paid to the taxing authority. However, for 2018 to 2025, individuals are able to claim an itemized deduction of up to only \$10,000 (\$5,000 for married filing separately) for state and local property taxes and state and local income taxes (or sales taxes in lieu of income taxes). Previously, there were no dollar limits.

If you pay your real estate taxes through an escrow account, you can only deduct the real estate taxes actually paid by your lender from the escrow account during the year. Only the legal property owner can deduct real estate taxes. You cannot deduct homeowner association assessments, since they are not imposed by a state or local government.

AMT considerations

If you're subject to the alternative minimum tax (AMT) in a given year, your ability to deduct real estate taxes may be limited. That's because, under the AMT calculation, no deduction is allowed for state and local taxes, including real estate tax.

Deducting points and closing costs

Buying a home is confusing enough without wondering how to handle the settlement charges at tax time. When you take out a loan to buy a home, or when you refinance an existing loan on your home, you'll probably be charged closing costs. These may include points, as well as attorney's fees, recording fees, title search fees, appraisal fees, and loan or document preparation and processing fees. You'll need to know whether you can deduct these fees (in part or in full) on your federal income tax return, or whether they're simply added to the cost basis of your home.

Before we get to that, let's define one term. Points are certain charges paid when you obtain a home mortgage. They are sometimes called loan origination fees. One point typically equals 1% of the loan amount borrowed. When you buy your main home, you may be able to deduct points in full in the year that you pay them if you itemize deductions and meet certain requirements. You may even be able to deduct points that the seller pays for you. More information about these requirements is available in IRS Publication 936.

Refinanced loans are treated differently. Generally, points that you pay on a refinanced loan are not deductible in full in the year that you pay them. Instead, they're deducted ratably over the life of the loan. In other words, you can deduct a certain portion of the points each year. If the loan is used to make improvements to your principal residence, however, you may be able to deduct the points in full in the year paid.

What about other settlement fees and closing costs? Generally, you cannot deduct these costs on your tax return. Instead, you must adjust your tax basis (the cost, plus or minus certain factors) in your home. For example, you'd increase your basis to reflect certain closing costs, including:

- Abstract fees
- Charges for installing utility services
- Legal fees
- Recording fees
- Surveys
- Transfer or stamp taxes
- Owner's title insurance

For more information, see IRS Publication 530.

Tax treatment of home improvements and repairs

Home improvements and repairs are generally nondeductible. Improvements, though, 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. 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. However, if repairs are performed as part of an extensive remodeling of your home, the entire job may be considered an improvement.

Exclusion of capital gain when your house is sold

If you sell your principal residence at a loss, you generally can't deduct the loss on your tax return. If you sell your principal residence at a gain you may be able to exclude some or all of the gain from federal income tax.

Generally speaking, capital gain (or loss) on the sale of your principal residence equals the sale price of your home less your adjusted basis in the property. Your adjusted basis is the cost of the property (i.e., what you paid for it initially), plus amounts paid for capital improvements, less any depreciation and casualty losses claimed for tax purposes.

If you meet all requirements, you can exclude from federal income tax up to \$250,000 (\$500,000 if you're married and file a joint return) of any capital gain that results from the sale of your principal residence. Anything over those limits is generally subject to tax. In general, this exclusion can be used only once every two years. To qualify for the exclusion, you must have owned and used the home as your principal residence for a total of two out of the five years before the sale.

For example, you and your spouse bought your home in 1981 for \$200,000. You've lived in it ever since and file joint federal income tax returns. You sold the house yesterday for \$350,000. Your entire \$150,000 gain (\$350,000-\$200,000) is excludable. That means that you don't have to report your home sale on your federal income tax return.

What if you fail to meet the two-out-of-five-year rule? Or what if you used the capital gain exclusion within the past two years with respect to a different principal residence? You may still be able to exclude part of your gain if your home sale was due to a change in place of employment, health reasons or certain other unforeseen circumstances. In such a case, exclusion of the gain may be prorated.

Additionally, special rules may apply in the following cases:

- If your principal residence contained a home office or was otherwise used partially for business purposes
- If you sell vacant land adjacent to your principal residence
- If your principal residence is owned by a trust

- If you rented part of your principal residence to tenants, or used it as a vacation or second home
- If you owned your principal residence jointly with an unmarried individual

Note: Members of the uniformed services, foreign services, and intelligence community, as well as certain Peace Corps volunteers and employees, may elect to suspend the running of the two-out-of-five-year requirement during any period of qualified official extended duty up to a maximum of 10 years.

Consult a tax professional for details.

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