Tax Aspects of Buying and Owning a Home

Lawrence Pon

CPA/PFS, CFP, EA, USTCP, AEP

www.larryponcpa.com

linkedin.com/in/lawrencepon

Today's Presenter

- Lawrence Pon
  - Lawrence Pon is a Certified Public Accountant, Personal Financial Specialist, Certified Financial Planner, Enrolled Agent, United States Tax Court Practitioner, and Accredited Estate Planner in Redwood Shores, CA
  - Mr. Pon has been in practice since 1986 and speaks regularly to tax professionals and financial advisors on the latest tax planning and preparation topics through out California and nationally.
  - Mr. Pon received his BS in Business Administration from UC Berkeley and MS in Taxation from Golden Gate University in San Francisco

Table of Contents

Buy vs. Rent

- Advantages of renting
  - Low initial investment
  - Renting costs less money
  - Limited responsibility
    - Landlord responsible for repairs
  - More mobility and flexibility
    - Lease terms
  - Insurance costs lower
    - Renters insurance

Buy vs. Rent

- Considerations for renters
  - Read and understand the lease
    - Legally binding
  - Protect security deposit
    - Walk through before signing lease
    - Document all pre-existing damage
  - Get renters insurance

Buy vs. Rent

- Advantages of buying
  - Cost of ownership can be less than renting
    - Fixed mortgage
  - Owner controls property
  - Forced savings
    - Paying down mortgage
  - Tax advantages
    - Mortgage deduction
    - Property tax deduction
    - Exclusion of gain on sale
  - Freedom to redecorate, remodel, or make improvements
  - Improve credit rating
  - Rent increases

Buy vs. Rent

- Considerations for home owners
  - Cost is not just the mortgage payment
    - Property taxes
    - Insurance
    - Maintenance & repairs
    - Association dues
  - Less flexibility to move
  - The market and home prices fluctuate
    - Real estate cycles

Buy vs. Rent

- Considerations in decision
  - Time horizon
    - Five years?
  - Affordability
    - Housing cost at 1/3 of income
    - Americans spend 37% of budget on housing
      - Over 50% in Bay Area

Down Payment

- What is a down payment?
- How much is needed for a down payment
  - 20% increases your chances of getting approved for a mortgage at a decent rate
    - Avoid mortgage insurance
  - Less than 20%
    - FHA loans
      - Backed by Federal Housing Administration
      - As low as 3.5%
    - VA loans
      - Backed by US Department of Veterans Affairs
      - No down payment
      - Current and veteran military service members and eligible surviving spouses

Down Payment

- USDA loans
  - Backed by US Department of Agriculture's Rural Development Program
    - No down payment requirement
    - Rural and suburban home buyers who meet the program's income limits and other requirements
- Down payment requirements vary by lender and borrower's credit history
  - Minimum down payment for FHA loan is 3.5% with a credit score of 580 or higher
  - Minimum down payment is 10% with a credit score of 500-579

Down Payment

- Larger down payment
  - Better mortgage interest rate
  - Lower upfront and ongoing fees
  - No or lower mortgage insurance
    - Private mortgage insurance
  - More equity in home
  - Lower mortgage payment
  - Lower risk to lender

Down Payment

- How to save for down payment
  - Start early
    - Automated plan
      - Deposit at every paycheck
    - Add windfalls
      - Bonuses
      - Stock vesting
      - Tax Refund
      - Gifts
      - Inheritance

Down Payment

- How to save for down payment
  - Slash your spending
    - Cut or reduce unnecessary expenses
      - Eating out
        - Learn to cook
      - Vacations
      - Review your expenses
  - Pay down debts
    - Pay off high interest rate debts
    - Snowball effect
  - Get a second job
    - Gig economy

Sources of Down Payment

- Savings
- Grant Money Assistance
  - First time home buyer assistance
- Retirement Plans
  - $10,000 from IRA accounts
    - Still taxable
    - Penalty free
    - Traditional IRA vs. Roth IRA
  - Retirement Plan Loans
    - $50,000 limit or 50% of balance of employer retirement plan

Credit Scores

- Credit reports affect credit card rates, auto loan rates, rental applications, job applications, and mortgage rates
- Review credit reports
    - www.annualcreditreport.com
        - Equifax
        - Experian
        - Transunion
    - List of business you have credit or loans
    - Amounts
    - Whether paid on time or not
    - Missed payments

Credit Scores

- Credit score
  - Scores from different companies are not the same
  - Different formulas to calculate credit scores
  - Different scales
  - Businesses do not always report to all the credit reporting companies
- What makes your score go up or down
  - How much money you owe
  - How long you owed it
  - How many accounts you have
  - How often miss payments or late with payments
  - Type or credit accounts

Credit Scores

- Score between 300 and 850
  - 300-629 = Bad
  - 630-689 = Fair
  - 690-719 = Good
  - 720-850 = Excellent
- Correct errors on reports
  - Negative information on credit report
    - Public records
      - Liens
      - Judgements
      - Bankruptcies
        - 10 years
      - Tax liens
        - 15 years

Mortgage

- Selecting a mortgage
  - Fixed
  - Adjustable
    - 5 year fixed
    - 7 year fixed
  - Amortization
- Appraisals

Mortgage

- What can you afford?
- Mortgage Tax Rules
  - Mortgage loan points
    - Prepaid interest
      - Deduct if in connection with
        - Purchase
        - Construction
        - Improvement of a principal residence
        - Secured by principal residence
          - Accepted business practice
          - Points charged are not excessive in relation to normal business practices
      - If not, amortized over the life of the loan

Mortgage

- Points
  - Not subject to mortgage interest deduction limits
  - Refinancing
    - Deduct unamortized points on old mortgage
- Form 1098 – Mortgage Interest Statement
  - Borrower's name
  - Borrower's SSN
  - 1 = Mortgage interest received
  - 2 = Outstanding mortgage principal
  - 3 = Mortgage origination date
  - 5 = Mortgage insurance premiums
  - 6 = Points paid on purchase of principal residence
  - 8= Address of property securing mortgage

Mortgage

- Deducting Qualified Residence Interest
  - 2018-2025: Home equity interest is no longer deductible
    - Unless used for construction or improvement of home
  - For new mortgages acquired after December 15, 2017:
    - Deductible limit is $750,000
  - For mortgages acquired before December 15, 2017
    - Deductible limit is $1,000,000
  - Only deductible by owner of property
- Refinancing mortgage
  - Paid cash?
    - 90 day rule

Mortgage

- Who gets the deduction?
  - Taxpayer can deduct mortgage interest payments that he or she actually makes on property of which the taxpayer is the legal or equitable owner (subject to the "qualified residence interest" limits), even if the taxpayer is not directly liable for the mortgage debt.
  - A taxpayer who is personally liable for a mortgage debt is entitled to a deduction for otherwise deductible mortgage interest payments actually made, even if the taxpayer no longer owns the mortgaged property
  - Where joint owners of mortgaged property are jointly liable on the mortgage, each owner may deduct the mortgage interest actually paid out of separate funds
    - If the mortgage interest is paid from a joint bank account in which each has an equal interest, each is presumed to have paid an equal amount, absent evidence to the contrary

Mortgage

- Taxpayer not owner of property
  - Mortgage on a personal residence
    - Only deductible if there is an ownership interest
  - Mortgage on a rental property
    - Taxpayer still liable on the mortgage debt
      - Entitled to deduct mortgage interest payments paid by own funds
- Not personally liable on debt
  - Only if legal or equitable owner of the mortgaged property
    - Bad or no credit
  - Reasoning by court
    - If bank forecloses, lose property

Mortgage

- Equitable Owner
  - Assumes benefits and burdens of ownership
    - Right to possess property
    - Enjoy its used, rents or profits
    - Duty to maintain property
    - Responsible for insuring property
    - Bears property’s risk of loss
    - Obligated to pay property taxes, assessments, or charges
    - Right to improve property without owners consent
    - Right to get legal title at any time by paying the balance of the purchase price
  - Not mere fact that property is taxpayer’s residence

Mortgage Insurance Premiums

- Mortgage insurance premium deduction extended through 12/31/21
  - Deduction is phased-out ratably by 10% for each $1,000 or fraction thereof, by which the taxpayer’s AGI exceeds $100,000.
    - If AGI over $109,000, no deduction

2nd Homes and Vacation Homes

- Personal residence – 2nd home
  - Rented out fewer than 15 days during the year
- Vacation home
  - Combination of personal and rental use
    - Personal use > 14 days or 10% of rental days
    - Rental use exceeds 14 days
- Rental Property with Personal Use
  - Property rented during the year and personal use is less than 15 days or 10% of rental days

2nd Homes and Vacation Homes

- Personal residence – fewer than 15 rental days annually
  - Income received is not taxable
  - No deduction for rental expenses
    - Mortgage interest and property taxes deducted on Schedule A

- Vacation Home
  - Short term rentals – sales and lodging taxes
  - Deductions are limited to amount of income
    - Mortgage interest and property taxes deducted on Schedule A
  - Days spent performing repairs and maintenance do not count as days of personal use

2^{nd} Homes and Vacation Homes

- Rental Property
  - Expenses may exceed rental income
  - $25,000 passive loss deduction

Real Estate Taxes

- Real estate taxes are imposed on real property or on an interest in real property
  - Measured by the value of real property
  - From 12/31/17 to 1/1/26, limit on deduction related to state and local taxes
    - $10,000 limit
- Improvements to property
  - Supplemental taxes
- Proposition 19

Homeowners Insurance

- Homeowners insurance covers losses and damages to house and assets in the home
  - Interior damage
  - Exterior damage
  - Loss or damage of personal assets
  - Injury that arises while on the property
- Not covered
  - Neglect
  - Failure to maintain property
  - Termites, insect, rodent, bird damage
  - Rust, rot, mold, and general wear & tear

Homeowners Insurance

- Considerations
  - Coverage adequate to replace the dwelling at its current value
  - Proper form of insurance
  - Inflation-adjustment rider
  - Policy exclusions
  - Additional umbrella liability policy
  - All policies written on the same basis
    - Claims made or occurrence

Homeowners Insurance

- Discounts
  - Smoke detector
  - Monitored smoke detector
  - Fire extinguishers
  - Deadbolt locks
  - Monitored security system
  - Other protective devices
  - Multiple policies
- Cost-effective deductibles

Casualties

- Personal casualty losses are not deductible for 2018-2025 unless attributable to a federally declared disaster
  - www.fema.gov/disasters/disaster-declarations
  - Loss deduction is subject to the $100 casualty limitation
  - Loss deduction is subject to 10% of AGI limitation
  - Loss is deductible in the year it was sustained
  - Report on Form 4684

Casualties

- Casualty
  - Damage
  - Destruction
  - Loss of property
- Resulting from
  - Sudden
  - Unexpected
  - Unusual identifiable event
    - Storm
    - Hurricane
    - Earthquake
    - Floods
    - Fire

Casualties

- What Does Not Qualify
  - Accidentally breaking items
  - Damage caused by pets
  - Fire you set or paid someone to set
  - Progressive deterioration
  - Damage caused by drought
  - Termite or moth damage
  - Damage to trees by fungus

Casualties

- If settlement or reimbursement from insurance may create an involuntary conversion gain
  - Total reimbursements exceed adjusted basis of property
    - Taxpayer may elect to defer such gain
- Insurance reimbursements for living expenses
  - May be taxable income
- Disaster-related assistance
  - Not considered taxable income
  - Not considered in calculating the amount of casualty loss

Energy Credits

- Residential energy efficient property credit
  - Solar electric property
  - Solar water heaters
  - Geothermal heat pumps
  - Small wind turbines
  - Fuel Cell property
  - Qualified biomass fuel property
  - 12/31/19 to 1/1/23 = 26%
  - 12/31/22 to 1/1/24 = 22%

Energy Credits

- Roofing materials and structural components do not qualify
- Solar roofing tiles and solar roofing shingles do qualify
- Residential energy property credit
  - Energy-efficient exterior windows, doors, & skylights
  - Roofs (metal and asphalt) and roof products
  - Insulation
  - Energy-efficient heating and air conditioning systems
  - Water heaters
  - Biomass stoves
  - 10% of cost with a lifetime limit of $500

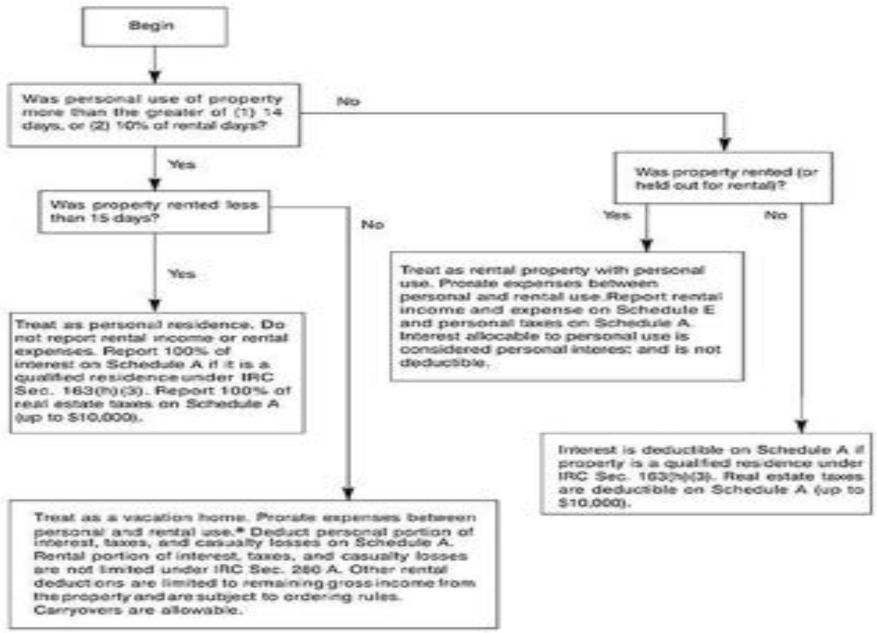
Energy Credits

- $50 for any advanced main circulating fan
- $150 for any qualified natural gas, propane, or oil furnace or hot water boiler
- $300 for any item of energy-efficient building property

Converting Home to Rental Property

- Compute basis for depreciation
- Gain or loss on converted property
  - Temporary rental
- Renting property to a relative
  - Tax Court – 20% discount
    - Substantiate rent with objective data
      - Discount equal to agency fees that would otherwise be incurred
  - May be considered personal property
    - Nondeductible personal loss
    - If no rent charged – expenses are not deductible

Flowchart to Determine Tax Treatment of Home with Rental and Personal Use



Notes: * For purposes of the vacation home rules, personal use days during the taxable year that occur before or after a 12-month (or more) consecutive rental period do not count as personal days [IRC Sec. 280A(d)(4)].

Medical Necessary Improvements

- Claim medical educations for cost of capital expenditures on the home
  - Deductible if medical expenses exceed 10% of AGI
  - Operating costs and upkeep also qualify as long as the medical requirement for the capital expenditure continues
  - Prescribed by physician
    - Elevator
    - HVAC with special filtration
    - Handicapped Access
- Do not add to cost basis of home

Selling a Home

- Excluding gain on the sale of a residence
  - $250,000 per taxpayer
  - Live and own property 2 years out of 5 years
- Partial Exclusion
  - Work-related move
    - Transferred to a new job at least 50 miles farther from home
    - Needs to apply to only one spouse
  - Health-related move
    - Moved to obtain, provide, or facilitate diagnosis, cure, mitigation, or treatment of disease, illness, or injury to yourself or family member
      - Family includes
        - Parent, grandparent, child, brother, sister, In-laws, uncle, aunt, nephew, niece
    - Doctor recommended change in residence

Selling a Home

- Unforeseeable Events
  - Home destroyed or condemned
  - Home suffered a casualty loss
    - Natural or man-made disaster
    - Act of terrorism
      - No matter if loss is deductible or not.
  - You, your spouse, co-owner, or anyone else for whom house is residence
    - Died
    - Became divorced or legally separated
    - Gave birth to two or more children from same pregnancy
    - Became eligible for unemployment compensation
    - Became unable to pay basic living expenses

Selling a Home

- Other Facts and Circumstances
  - The situation causing the sale arose during the time you owned and used your property as your residence
  - You sold your home not long after the situation arose
  - You could not have reasonable anticipated the situation when you bought your home
  - You begin to experience significant financial difficulty maintaining the home
  - The home became significantly less suitable as a main home for you and your family for a specific reason

Stretch To Buy a Home?

- Buy now or wait?
- Buy now
  - Interest rates are low
  - Housing prices unlikely to come down
  - Grow into it
  - Build wealth
- Wait
  - Don’t count on home prices continuing to rise
    - Interest rates expected to stay low
  - Seller’s market can shift to buyer’s market
  - Job stability

Types of Homes

- Single family homes
- Duets or duplexes
- Condominiums
- Townhouses
- Mobile homes

Homeowner Associations

- Private association and usually tax exempt
  - File Form 1120-H
- Formed to make and enforce rules regarding properties in a jurisdiction
- Single family homes or condominiums
- Run by community residents
- May impose fines
- Read the minutes of association minutes
- Review financial statements

Working From Home

- Employees
  - No deduction for unreimbursed business expenses
  - Reimbursement from employer
  - Allowance from employer
- Self employed
  - Home Office Deduction
  - Form 8829
    - Actual costs
    - Simplified method

Shared Equity Financing Arrangements

- Shared equity financing arrangement whereby parents or other relatives share in the purchase and cost in maintaining a house used by the children as a principal residence
  - Nonresident-owner rents his portion of the home to the resident-owner
    - Obtains normal tax benefits of renting real estate
  - Parents agree to help son by a first home.
    - Purchase price = $1,000,000
    - $200,000 down payment
    - $800,000 mortgage
    - Son pays fair rental for using 50% of property
    - Son treats property as principal residence
      - Deducts 50% of mortgage interest and property taxes
      - Pays rent to parents
      - Parents file Schedule E for the rental property

Buyers Remorse

- Hot real estate market
  - Hasty purchases
- Unlike other purchases, cannot return house to seller
- Get property inspection
  - Homeowner spent $3,500 on removing bats
- Talk to an insurance agent
  - Home insurable at a reasonable cost?
- Look at the property
  - Woodpecker
  - Aircraft noise

Steps To Buying a Home

- Mortgage application and approval
  - Down payment
  - Credit record
  - Shop around
    - Get recommendations from people you trust
- Getting the home appraisal
- Getting the home inspection
- Review contingencies and closing costs
- Be patient

Steps To Buying a Home

- Don’t overpay
- Don’t settle
  - Pick wrong neighborhood
  - Over extending
  - Wrong size house
- Don’t lock up your money
  - Are you really ready to be home owner?
- Don’t panic

Previous Webinars & Videos

- Tax Aspects of Selling a Home
  - https://youtu.be/4F71WHfq4Lk
- How Does Proposition 19 Affect You?
  - https://youtu.be/UA0YT_gNpBY
- Tax Planning with Real Estate
  - https://youtu.be/KAhKJaeLvUY
- Advance Child Tax Credit Payments
  - https://youtu.be/D8VI-TEATz8
- American Families Plan
  - https://youtu.be/5atT4aVCJ7c
- American Rescue Plan
  - https://youtu.be/dgv1_r9Qlxg

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