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Home Ownership - Income Tax Basics

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Introduction and Generalizations

Congratulations, you are now a home owner. You have gone through the process and emerged (relatively) unscathed. Now, all you've got to do is figure out how the old couch fits in the new living room… and deal with your purchase's income tax implications.

Fortunately, most of your purchase's income tax implications are favorable. The U.S. tax code provides income tax incentives for home ownership.[1] Most state income tax statutes, including California's, mirror the Federal statute. The income tax incentives include:

- ✓ Itemized deductions for some of your operating expenses (mortgage interest and property tax),
- ✓ Favorable tax treatment when you sell your home, and
- ✓ Tax credits when you alter your property in eco-friendly ways.

These income tax benefits are both reasonably transparent and relatively risk free. Your income tax returns may become slightly bulkier but your "audit risk" remains about the same.[2]

Our discussion covers the personal income tax impacts of your main home (principal residence) and (within newly created limits)[3] a second home that is not rented-out on a consistent basis.

We don't talk about other real estate investments or other kinds of tax here (except as they affect your residential income tax). If you rent-out your residence (including, e.g. Air B&B rentals) or you conduct business from your home (and take the associated deductions), the rules change radically. This discussion does not address those rules.

So, what are we talking about: With due respect for Burt Bacharach and David Hay, "A house <u>is</u> a home" for income tax purposes – as is a condominium, cooperative, mobile home, house trailer, boat, or other structure that has *sleeping, cooking, and toilet facilities*. Whether that home is your "principal or secondary residence" is a question of fact. We consider that nuance later.

Income tax implications attend each stage of home ownership:

1. Pre-Purchase
2. Purchase
3. Ownership and Operation
4. Sale and Reinvestment

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[1] This discussion is based on the U.S. tax code as it exists on March 30, 2019. This is a "fluid" tax subject that changes frequently. Consult your own tax representatives before relying on this presentation.

[2] Third party (lender) reporting of most of the tax-significant information that goes on your return gives the IRS an efficient cross-check on your return's accuracy. Unless you report numbers that are vastly different from third-party figures, you will probably never hear from the Service regarding this part of your return.

[3] The Tax Cuts and Jobs Act (TCJA) enacted in late 2017 alters the treatment of both primary and secondary residence itemized deductions in tax year 2018 and later years. Deduction limits under TCJA are, generally, more restrictive than under prior law. Rather than dwell on "whose ox got gored, and how badly" this discussion simply presents the rules without considering their social or income distribution impacts. If you want our (Steven's opinion on TCJA's social impacts, you will have to buy him breakfast or lunch.

Within that rubric, we discuss

1. Expenses and events that generate immediate income tax benefits (deductions) or obligations,
2. Costs and events that affect the gain you report (and the tax you pay) when you sell your home,
3. Opportunities (if any) to garner tax credits through eco-friendly development of your home,
4. Expenses and events that have no income tax implications, and
5. Records you need to retain.

Before we begin, two cautions:

First: Discussions of home ownership and income tax usually focus on "How much am I going to save on my taxes?" That approach permits a very small tail to wag a very big dog. Most people don't find it particularly comforting to know they "saved $4,800" by excluding gain from the sale of their principal residence when they are handed the bill for the remaining $13,000 they "didn't save." Tax planning (at least in our discussion) focuses on maximizing economic performance of your asset while mitigating tax exposure and planning for tax obligations – not on the "dollars saved."[4]

Second: This discussion isn't a Do-It-Yourself guide to handle your income tax compliance, planning, or representation – It is much too superficial for that. Rather, it is designed to make you aware of opportunities and pitfalls and to facilitate your communication with a qualified tax professional.

[4]We sometimes maintain we have never "saved any taxes" our client and the tax code hadn't already saved.

Before you Purchase your Residence

Long before you haunt real estate websites or visit open houses, taxes constrain your options.

Why and How?

Purchasing a home almost always requires more money than you have readily available. Money you don't have, you have to borrow.

In the current "post-crash" credit environment, lenders have retreated from asset based lending. Most Lenders base their lending decision on income and cash flow. The lender uses your tax returns to assess your ability to make payments.

All but a few lenders have tightened cash flow standards for income based lending. Further, they have adopted inflexible ratio-based standards for debt coverage and leverage.[5] The net result: You probably won't qualify for as big a loan as you might have several years ago. If you qualify, it isn't easy. It follows that:

> **Aggressive tax strategies that reduce your taxable income interfere with your ability to purchase a home. Put another way, maximizing your deductions, minimizing your tax, and buying a house are mutually incompatible objectives.**

So, how do you compensate? We have yet to meet anyone who likes this answer:

> **Increase your down payment, generate more income, or report more taxable income and pay more tax for a year or two before you start your home search.**

Self-employed business operators often commingle personal and business expenses to reduce their tax exposure. Yeah, your tax professional knows it, so does the IRS, and so do most bankers-lenders: most of the time nobody takes it very seriously.[6]

Bankers, on the other hand, ignore it if that suits their convenience. They treat your tax return as gospel. One way to increase your taxable income is to stop doing the "can I get away with it?" routine.

Review your return to see if (e.g.) you should report less travel, meal and entertainment, and auto expense (or other "red flag deductions"). If you're in the habit of overstating these items, you'll acquire a virtuous rosy glow as a side benefit.

Caution: If your lender is smart enough to ask; "so where is your agent's commission," don't lie! Tell them you don't deduct it because it triggers alternative minimum tax and let them draw their own

[5] As well as imposing seemingly bizarre underwriting requirements. E.g. We recently dealt with a lender who required the borrower to "prove" they were the sole shareholder of their loan-out corporation. This, despite having done business with the owner-borrower for over 40 years. The lender would not accept either the owner's K1, the minutes of the Board meeting in which the shareholder's interest was granted, or the stock certificate and stock transfer ledger (in which the only entry was the original stock issuance). Since the borrower lived in a state that does not require notice of issuance – we eventually had to move the transaction to another lender.

[6] It is considered when the Service examines your return, however.

conclusions. Telling them you don't incur the expense or that you don't have an agent undermines your credibility and may even be bank fraud.

Mixed use allocations (e.g. Office in the home) are often over-represented in self-employed returns. Most underwriters are not sophisticated enough to recognize that these items are not separate and distinct from the living expenses that you report on the loan application. They subtract them twice when they compute free cash flow and debt coverage. The simple solution? Don't take these deductions for a couple of years. You may find that there is very little impact on your tax liability… unused carryovers from earlier years get used up before you see any difference.

These are just a couple of suggestions that improve the look and bankability of your tax returns. Any competent tax professional can probably, with knowledge of your situation, suggest about a dozen more.[7]

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[7] In previous editions we dwelt lovingly on the nuances of Alternative Minimum Tax (AMT) deductions and their effect on bankability. Good News: TCJA obviated that discussion. Bad News: TCJA repealed most of the deductions that made that discussion relevant.

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When you Purchase your Residence:

You've made the offer, done the negotiation, been through the escrow, taken possession, your car is in the garage and you have a gigantic pile of paper that documents the process in excruciating detail. A few months later you make a tax appointment, where you find that most of the paper is not relevant to your income tax.

The RESPA,[8] HUD-1, or Settlement Statement is an exception. Some of the information on the RESPA Statement has immediate or eventual income tax implications.

Immediate Deductions

You may "Itemize" (deduct) some of the expenses on the settlement statement in the you're your escrow closes if you elect to do so.[9] Once they exceed a threshold,[10] Itemized Deductions reduce taxable income – the amount on which you pay income tax. Hence, itemized deductions mitigate your income tax exposure.

Your lender is responsible for reporting[11] some (but not all) of the tax relevant information. Some lenders are better about this than others. Verify that your lender or your accountant picks up the deductible items (and any adjustments that reduce otherwise deductible items, fair-is-fair after all). The most common immediately deductible items on the Settlement Statement include:

1. Pro-rated property taxes
2. Loan Origination fees and Points
3. Pro-rated interest
4. Pro-rated mortgage insurance (maybe)[12]

Claim deductions by "itemizing deductions" on Schedule A of your individual tax return for the tax year in which the purchase closes. Formally, the sale closes on the earlier of (a) the date title transfers or (b)

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[8] RESPA = Real Estate Settlement Procedures Act, enacted in 1974 and amended periodically since – most recently in 2011.

[9] When computing taxable income, Federal procedures provide two options: a) a "standard deduction" and b) "itemized deductions." With two exceptions, you may elect to apply the standard deduction or choose to itemize each year. In most cases, the decision is straightforward: Choose the one that is biggest.

{The first exception concerns married spouses who file separate returns – the spouses must make consistent elections. The second exception applies to nonresident aliens – who may not itemize unless they also elect to be taxed on their worldwide income. (Residency for tax purposes is more inclusive than residency for immigration purposes!)}

The standard deduction is based on marital status (determined on the last day of the taxable year). Itemized deductions include those items the Code recognizes as deductions (yes, that is circular, but it is also true).

[10] TCJA increased the "standard deduction" and eliminated the "personal deduction." This alters the dynamics and economics of the decision, but not the underlying principle.

[11] The lender issues Form 1098 to report items the lender is responsible for. The mortgage interest and origination/points should include any pro-ration that is paid pursuant to closing. This, however, is the most common error of omission on the first year 1098.

[12] As of today, Mortgage Insurance is deductible. However, that may change. This has become a political football.

the date the economic burdens and benefits of ownership shift to you. In most cases, these dates are the same.

Items That Affect Gain When You (Eventually) Sell

Some RESPA statement items do not generate immediate deductions, but eventually influence the tax you pay when you sell the residence.

If you and/or your accountant don't capture this information from the RESPA statement, you will find yourself searching for it among dusty paperwork when you (or your heirs) sell the residence.

On the day you purchase your residence, your "tax basis" (the amount you have invested in the property and may use to offset gain when/if you sell) includes:

1. Purchase (contract) price[13]

And, if you (the buyer) pay them:

2. Allowances and Adjustments (e.g. add Seller's Delinquent Property Tax[14], and subtract Repair Allowances) (This information, if present, may be just about anywhere on your RESPA statement)
3. Real Estate Broker Fees
4. Appraisal, Credit Report, Tax Service Fees, and Flood Certification
5. Title Charges
6. Recording and Transfer Charges
7. Escrow
8. Miscellaneous (Junk?) charges, e.g. messenger fees, notary, prep fees…

The costs incurred to secure financing (except for "points and origination), are neither deductible nor added to basis.

We suggest that you capture this information and keep it in a safe place – segregated from your annual operating records – immediately after your Escrow closes. Escrow companies retain the records for only a limited time. It is difficult to replace the information twenty or so years later if you accidentally tossed it with your statute expired annual receipts.

Tax Credits When You Purchase

There are, at present, no Federal income tax credits that relate to your residential purchase. The last available credit, the "First Time Home Buyer Credit," expired in 2010.

If you anticipate you will claim the Mortgage Interest Tax Credit, your lender must validate your eligibility before you close on the property. (We talk about this later.)

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[13] Contract Price is usually the largest item on the settlement statement. Most people cannot accurately recall this number when it comes time to sell their residence. Ironically, people usually remember it being lower than it really was – thus exposing themselves to additional tax liability when they sell the property.

[14] When you pay the seller's delinquent tax it becomes part of your "basis" in the property. You may not deduct the tax immediately because it is not your obligation.

First Time Buyer Programs

There are a plethora of state, local, and institutional direct subsidies, credits, and programs that first-time home buyers can access. Ask your Realtor® or loan broker for guidance with these programs. Odds-on your tax advisor knows very little about them.

Items That Have No Income Tax Implications

Some of the costs you incur when you purchase a home have no income tax consequences either immediately or when you sell your home. E.g. impounds and prepayments for property tax, mortgage insurance, and home insurance you deposit in escrow with the lender.

Escrowed property tax and mortgage insurance become deductible when the lender uses escrow funds to pay the amounts due. Usually, these items are reported annually by the lender on IRS Form 1098. Home insurance and "reserves" are non-deductible personal expenses even when paid from your lender's escrow.[15]

Retaining Records of the Purchase

In California, you need to keep your entire Purchase and Initial Finance Package until 3-4 years after you dispose of the residence.[16] Other states have different record retention rules. Check with them if you buy property outside California.

[15] "Forced placement" home insurance is usually much more expensive than coverage you could obtain in the open market. The lender may love their carrier, but that's no reason why you should.

[16] The Federal statute of limitations for record retention and production extends to three years after the last return on which information is relevant. California's (and most other state's) statute extends that by a year. The Settlement Statement remains relevant for as long as you own the residence. The statute can be extended, perhaps indefinitely, if there is evidence that suggests gross negligence or fraud. Absence of records that substantiate basis is considered emblematic of gross negligence or fraud – so hang on to those purchase papers!

Owning and Operating Your Residence

Almost every discussion of home ownership in America begins or ends with the phrase, "Think of the taxes you will save!" The discussion usually focuses on the Big Three.

1. Itemized Deductions for Mortgage Interest and Mortgage Insurance,
2. Itemized Deductions for Property Tax, and
3. Exclusion of Gain when you sell

It's difficult to argue with the numbers: In recent years,

1. Thirty-Five Million taxpayers claimed annual Mortgage Interest Deductions, reducing their Federal Tax Bills, on average, by $1,850 ($64.5 Billion/year in aggregate).[17]
2. Forty Million taxpayers claimed annual Property Tax Deductions, shaving $600 from their Federal Tax bill ($24.5 Billion/year in aggregate).[18]
3. Five Million taxpayers claimed the Gain Exclusion, reducing their Federal Tax Bill by $4,800 on average ($24.5 Billion/year in aggregate).[19]

Together, the Big Three reduce Americans' annual Federal Income Tax bill by about $112.5 Billion. State provisions generally mirror the Federal code and reduce state income tax bills by another $38 Billion. It is little wonder that these deductions have often been viewed as "Sacred Cows," sacrosanct in discussions of tax reform.[20]

Just as we did for the Purchase scenario, we break down residential expenses in three categories: Those that provide immediate deductions, those that affect gain when you sell, and those that have no tax implications. Our discussion is based on the existing rules as of March 30, 2019.

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[17] TCJA has some, albeit limited, affect on this figure. TCJA reduced the residential home interest deduction to "interest on $750,000 of acquisition indebtedness." (Prior law allowed deductions for up to the interest on $1,100,000. Except in high property-value venues (e.g. most urban areas, and almost anywhere in New York, California, Massachusetts) the change will have insignificant effect.

[18] TCJA reduces the efficacy of property tax deductions. Under prior rules, State and Local Tax (SALT) deductions were unlimited… If you paid them, you deducted them. TCJA limits the SALT deduction to $10,000. If you can afford a house in high state-tax jurisdictions (e.g. New York, California, Massachusetts) your state income tax liability probably exceeds the $10,000 deduction limit. Arguably, if that is the case, state and local property taxes provide no incremental (marginal) tax relief.

[19] TCJA did not change the gain exclusion provisions. Hence, this figure probably remains about the same as the historical average.

[20] Most of us discuss itemized deductions as if they are inevitable – "if you have them, use them." Itemized Deductions are optional. Roughly 20% of people entitled to itemize deductions choose not to do so. Instead, they claim the "Standard Deduction" and file much-simplified tax returns. Reasons cited for this decision include: Audit Aversion, Life Simplification, and Lack of Tax Effectiveness. Audit Aversion is probably not justified in this context (this deduction is not a high audit priority), but an existential case can be made for Life Simplification. Lack of Tax Effectiveness usually arises from one or both of two primary sources: 1. the taxpayer is in a low marginal income tax bracket (making it "not worth the hassle"). Or, 2. The taxpayer is subject to alternative minimum tax (so, additional itemized deductions, with some exceptions, do not reduce their tax exposure). TCJA (by reducing tax rates, raising the Itemization threshold, and all but eliminating the Alternative Minimum Tax) strengthens both arguments and will probably increase the number of people who forgo otherwise Itemizable deductions in service of simplicity.

Impact of the Tax Cuts and Jobs Act

I said we weren't going to talk about TCJA's impact on specific demographic and economic groups. Not to sound too much like Huey Long, but "I Lied." The reason it is necessary to talk about it is several-fold:

1. TCJA severely restricts State and Local Tax deductions in high-property-value, high state-income-tax venues.[21] The impact may make itemization ineffective or even irrelevant.
2. TCJA eliminates non-residence deductions (Employee Business Expense, Investment Expense) that loom large in some home-owner's pre-2018 tax scenarios. In the absence of those deductions, the residential deductions must – almost by themselves – satisfy the itemization threshold.[22]
3. TCJA dramatically raises the itemization threshold itself. This is good news if you are not itemizing. It reduces the tax-efficacy of your deductions if you itemize.
4. Even some of the best stuff in TCJA has anomalous effects: Lower tax rates (at the same income levels) reduce the present value of tax savings from your deductions.

Each of these factors operates to reduce the present value of future itemized deduction tax savings. In combination, they should (if we were all rational beings) reduce the price we are each willing to pay for any given property. Think about the implications of that when planning your residential purchase and future sale.

Immediate Deductions

Several expenses you incur to own your home may reduce your state and federal income tax for the year you pay them (if you Itemize them):

1. Mortgage Interest (but not mortgage principal),
2. Property Tax, and
3. Mortgage Insurance, PMI (maybe).

If you have been following our publications for a while, you may note that this list is 25% shorter than previous iterations: "Expenses You Incur to Protect Title" are no longer immediately deductible[23] – They may arguably increase your Basis (and reduce your gain) when you sell the property.

Threshold rules for each of these deductions are the same as for other Itemized deductions: A) You must file as a U.S. citizen or permanent resident, and B) Non-resident aliens cannot Itemize unless they file their return "as-if" they are residents – reporting and paying tax on their worldwide income.

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[21] Technically, the restrictions apply everywhere – but they have the most impact in high-property-value, high state-income-tax venues. In places like Tennessee (no state income tax) you may not even notice the difference.

[22] Not rigorously true – If you are a charitable donor you may use those deductions to meet the threshold as well.

[23] TCJA repealed, in toto, the Federal deduction for Miscellaneous Itemized Deductions – including expenses for title defense. These items are, arguably at least, attributable to your Basis in the property. Hence, though the immediate itemized deduction is gone, you may ultimately reduce your reportable gain when you dispose of the property. As if this was not complicated enough already – several states (including California) did not conform their codes to TCJA. In these states, it may still be possible to itemize miscellaneous deductions, and forgo the adjustment to Basis. (Giving birth to a discrepancy between your state and federal basis.)

You may deduct these expenses if you incur them for either your main home or a second home that you own.

A "home," for this purpose includes a house, condominium, cooperative, mobile home, house trailer, RV, boat, or any property that has sleeping, cooking, and toilet facilities.

The home can be your pied-a-terre, a mountain cabin or any other structure that has sleeping, cooking, and toilet facilities – and which is not rented/leased for a significant part of the tax year.[24]

To qualify for itemized deductions, you must be both;

- The owner of the property (or one of the owners), and
- Obligated to make the payment.[25]

In real-estate-tax-speak, we say you must be both on-title and on-mortgage.

Each of the deductions has unique requirements or limitations in addition to the general requirements:

Mortgage Interest is deductible if (in addition to satisfying the general rules) the debt on which the interest is paid is secured by the residence. That is, the debt

1. Makes your ownership interest in a qualified home security for payment of the debt,
2. Provides, in case of default, that your home could satisfy the debt, and
3. Is recorded or is otherwise perfected under any applicable state or local law.

The Mortgage Interest Deduction is limited to Interest paid on the first $750,000[26] of acquisition or home equity indebtedness. (Provided the home equity indebtedness was used to improve the property. Tracing rules apply.)

Unless you refinance, acquisition indebtedness includes the balance of your First Mortgage (up to $750,000) plus money borrowed and used to improve or add to the property (if the debt is secured by the property).[27]

If your total secured indebtedness exceeds $750,000 (or the grandfathered amount), interest is deductible pro-rata based on the fraction $750,000/total indebtedness (E.g. 75% of interest on secured debt of $1,000,000 is deductible).

Refinancing, particularly cash-out scenarios, complicates this simple generalization.

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[24] Special rules and reporting apply to rentals that exceed fourteen days, in aggregate, during a tax year. Those rules are well beyond the scope of this introduction. Talk to a qualified tax professional if you find yourself in this scenario.

[25] The most common "fail" here? The good son or daughter pays a parent or grandparent's mortgage or property tax. Nobility notwithstanding, unless they are on title (and/or the mortgage), they are not entitled to a deduction – the payments are gifts to the parents or grandparents, not interest or property tax. Adding insult to injury, they can't deduct the interest --- but they may need to file a gift tax return.

[26] Prior law allowed interest on up to $1,000,000 of acquisition indebtedness, and $100,000 of home equity indebtedness. Properties acquired under prior law are "grandfathered" under the new rules.

[27] The security requirement makes interest on "Credit Card Construction Loans" non-deductible.

Mortgage Points and Origination Fees: Points and origination fees you incur to purchase your residence are deductible as mortgage interest in the year they are paid, usually the year your escrow closes, and title passes. Your lender usually reports Points and Origination fees on the RESPA statement and on the Form 1098 you receive at the end of the year.

Points and origination fees you incur to refinance your home are subject to a different, less advantageous, regime. (They are amortized over the life of the loan, or the unamortized balance is claimed when the loan is paid off.) Your lender reports these on a RESPA refinance statement and a Form 1098 for the year the refinance closes – but it is up to you and your accountant to properly account for and amortize them.

Mortgage Insurance is currently (2018) deductible, subject to the same general rules as other mortgage interest and property tax.

The Mortgage Insurance deduction has been on-again-off-again in recent years – deductible in some years, not in others, lapsed and retro-actively reinstated in several years. TCJA made no permanent change to this deduction. Stay tuned-in for further developments.

Property Tax: TCJA added a significant new twist to Itemized Property Tax Deductions.

In TCJA's wake, property taxes on your principal residence remain "deductible." Property taxes are, however, aggregated with other State and Local Taxes (Income Tax, Property Tax, and Motor Vehicle Taxes). The aggregate deduction cannot exceed $10,000. Ironically, if you can qualify to purchase a house in most high property value – high state income tax venues, the property tax deduction doesn't provide much-if-any Federal income tax benefit.

Some assessments included on your "property tax bill" are not, technically speaking, taxes and do not qualify as deductions. Other special assessments represent improvements that increase your basis in the residence. Have a qualified tax consultant review your assessment and deduct or capitalize them accordingly.[28]

To gain perspective on how TCJA's restrictions work, Here is a brief example – in a high tax venue, Suffolk County, NY:

The median home price in Suffolk County is $1,228,200. Applying generic underwriting criteria (20% Down, ~30% Debt/Income Qualifying Ratio) – qualifying buyers must make roughly $275,000 per year to purchase a home in Suffolk. Suffolk's property tax rate is 2.2%.

	Incurred	Deducted	Difference
Mortgage Interest (~$860,000 Loan Balance)	**$34,400**	**$30,010**	**$ 4,390**
State Income Tax	$17,200		
Property Tax	$27,020		
Total SALT Taxes	**$44,220**	**$10,000**	**$34,220**

[28] Special (non-tax) assessments and the correct computation of the Mortgage Interest Deduction limit on refinanced acquisition debt are the two most common errors we encounter on simple itemized returns. The IRS does not seem to challenge these deductions very often – even though they represent an "easy win" in most cases. One gets the impression that the amount at risk is too small to bother with, or that IRS personnel don't get the concept either.

	Incurred	Deducted	Difference
Total Itemized Deductions:	**$78,620**	**$40,010**	**$38,610**
Implied Tax Savings or Cost (Rate = ~31%):	**$24,280**	**$12,360**	**$11,920**

TCJA thus reduces the annual tax benefit of home ownership by nearly half – in high-cost markets like Suffolk, Los Angeles, or San Francisco. Put another way – TCJA reduces the present value of residential ownership by roughly $200,000 in those areas.

Expenses Incurred to Perfect or Protect Title may no longer be deducted[29] but some of them may be capitalized (added to your tax basis in the property). Legal, survey, and title search expenses that are incurred in boundary, easement, or encroachment disputes are candidates for capitalization.

Impound Accounts: Lenders frequently require first time buyers to fund and maintain an impound account from which the lender pays property taxes, mortgage insurance, home insurance, and other periodic payments of items that could affect the value or priority of the lender's lien.

Payments that you make (usually with your monthly mortgage payment) into the impound account are not deductible. You are the nominal owner of the account, therefore you are not "paying" the obligations. You are saving money so they can be paid.

Payments the lender makes from the account are deductible in the year paid, if they pay items that are deductible. The lender must provide an annual accounting for funds deposited and disbursed from escrow.

Items paid from escrow are subject to the same limitations they would face if you paid them directly.

Items That Affect Gain When You Sell

Some costs you incur while you own a property affect (add to or subtract from) your basis and, eventually, the gain you report when you sell the property. The process of adding to (or subtracting from) basis is called capitalization. The resultant figure is called "adjusted basis."

At any given time, if a property has not been rented or used in your business, adjusted basis includes:

- The contract price you paid for the property (See "When You Purchase Your Residence"),
- Items from the RESPA statement that you capitalize (See "When You Purchase Your Residence"),
- Cost of Additions, Improvements, Betterments and Upgrades you place on the property (loosely defined – things that add long term value and/or functionality to the property),
- Cost of Replacements (e.g. disaster repairs), less any insurance recovery,
- The cost of extending utilities to the property,
- Property Tax Assessments for items that increase the value of your property, (e.g. separate assessments for streets, curbs, or sidewalks), and
- Expenses you incur to protect, prove, or preserve title (if you capitalize them).

Some events in your property's lifecycle reduce your basis. Most common examples include;

[29] As noted above, TCJA repealed the deductions for "Miscellaneous Itemized Deductions," including this one.

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- The amount of insurance proceeds you receive for replacement costs (already implicit above – but worth repeating),
- The amount of deductible casualty losses that were not covered by insurance and were deducted on your tax return,[30] and
- The amount you receive for granting an easement.

As with deductible items, some general rules apply to basis items:

No double dipping: The first part of this is obvious and straightforward: items that you deduct and non-deductible operating expenses cannot be added to basis. Hey, fair is fair. The second part of this is less intuitive and may require some record adjustment: Items that you build and then remove (e.g. hardscape and fences) do not increase basis.

Sweat equity doesn't count: Your labor, and in most cases your family's labor, does not increase or decrease basis.

Inflation and market value changes do not increase or decrease basis.

Some observations apply to specific basis adjustments:

Except at the extremes, improvements, betterments, additions and replacements (which affect basis) are hard to distinguish from maintenance (which is neither deducted nor capitalized): Replacing a light bulb, faucet or a fixture is maintenance, replacing entire systems or substituting alternatives creates a basis adjustment. Everything in between is a judgement call.

The IRS finally (after nearly thirty-five years) issued rules for determining which is which. Those rules may not do what the Service intended… They favor "improvement" in preference to "maintenance or repair." The more expensive the job, the more likely it is an improvement under the new rules. When you undertake major projects, ask your tax consultant what they think.

As we noted above, your Property Tax bill probably includes items that are not, technically speaking, taxes and do not qualify as deductions. Many of these items ("Specific Assessments") can, however be added to basis. If you can't deduct them, maybe you can capitalize them.[31]

Expenses to protect, prove, or preserve title (e.g. legal and survey expenses incurred in boundary, easement, or encroachment disputes) are properly capitalized, not deducted.

Sometimes, the IRS gets practical. Adjusting (reducing) basis for amounts you receive for an easement is a case in point. The Service could consider this the sale of a partial interest in the property, require immediate reporting and assess tax when the easement is granted. That approach, and the valuation issues it raises, virtually guarantees that many these transactions would create "taxpayer disputes" and a significant number of them would end in litigation. In preference to that,

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[30] TCJA altered the circumstances under which "casualty losses" are deductible. In 2018 and subsequent years, "Casualty Losses" include only those incurred in a Federally declared disaster event.

[31] This, and other capitalization decisions, may require a thorough and sophisticated recordkeeping system. Without a record retention system, it may be quite difficult to remember, in the twentieth year of ownership, that you paid for an assessed improvement (gradually, between the fourth and ninth year of ownership).

the Service reduces basis – deferring tax until valuation is established in a market transaction. Practical, huh?

Tax Credits When You Operate or Improve Your Residence

Deductions are overrated! Tax credits are the Holy Grail of both tax planning and tax policy. Ask us why and we'll be happy to explain!

More important than that explanation, a wide assortment of energy-friendly investments in your residence generate Federal tax credits.

Federal credits apply to:[32]

- ✓ Solar-electric systems,
- ✓ Solar water heating systems,
- ✓ Fuel cells,
- ✓ Geothermal heat pumps,
- ✓ Wind turbines.

Even the car in your garage can earn you a credit for qualified plug-in electric drive vehicles and charging stations.

Thousands of dollars of direct Federal tax subsidies for doing "good" and doing what you wanted to do in the first place… Tax management doesn't get much better than that!

But wait, there's more!

States, counties, cities and some utility companies offer additional subsidies that are sometimes more generous than the Federal credit or subsidy. In some cases, credits and subsidies reduce the cost of being energy efficient by as much as 75%. And, that is before you consider energy cost savings.

Caution, Soapbox Sidebar (with little or no relevance to tax issues): There is a curiously persistent notion that alternative energy (e.g. solar) is more expensive than conventional carbon fuel energy. While that was true thirty to forty years ago, it is no longer true. Current technology and sourcing reduces the cost of alternative energy sources to below the cost of conventional energy in almost any scenario where the cost of carbon energy (or its BTU equivalent) exceeds about $50/bbl.[33] In short, at almost any time in the last 20 years, alternative energy (solar) has been cheaper than conventional carbon based sources - before considering the available technology credits and subsidies. So, every home owner should consider the potential of alternative energy! Save wear and tear on the environment and money too…. Sounds good to us. (End of Soapbox Sermon.)

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[32] Several "Non-business Energy Property Credits" (e.g. for Additional insulation, Energy efficient exterior windows, Energy-efficient heating and air conditioning systems) expired at the end of 2017. In past years these credits have been "extended," often retroactively, after they were allowed to expire. Given the composition of our present Congress, we don't hold out much hope for a similar result in 2018. Stay tuned anyway – we'd love being wrong about this.

[33] Another idle curiosity: Solar efficiencies are usually presented by reference to oil prices and solar is equally often posed as a remedy for oil import imbalances. In fact, solar and oil do not cross correlate very well… because very little oil is consumed for power generation. The bulk of power generation (in the U.S.) is coal fueled… the dirty little secret of both the solar and the conventional power industries.

Whew, glad we got that out of our system.

The details of the Federal tax credits for any of these items are complex… (four to six separate credits, each with their own peculiarities, plus state, local and utility issues) and well beyond the scope of a basic introduction. Talk to your tax advisor (good advice in any case) for further information.

But First:

A Cautionary Tale, Solar Leases: In Southern California, a prominent actor {who "hardly ever endorses a product" (unless the price is right)} has been promoting the concept of solar leases… a "no money down" approach to installing solar. The advertisement emphasizes the cost savings of installing solar without owning the system, and scrupulously avoids mentioning that you won't get the credits or subsidies either. The advertisements are accurate, as far as they go… But omit one important detail; the solar lease adheres to (becomes "appurtenant to") the property. Hence, any future buyer of the property must also agree to the solar lease terms. This creates difficulties when you try to sell.

Items That Have No Tax Implications

Some items (call them general operating expenses) are neither deductible nor capitalized while you own your home:

1. Association and Cooperative dues,
2. Cleaning,
3. Insurance (Home policy),
4. Gardener (and many landscaping expenses),
5. Maintenance and repairs,
6. Pest control,
7. Supplies,
8. Telephone, Cable, Satellite, and/or Internet, and
9. Utilities
10. Any "personal living expense" not specifically made deductible by the Tax Code.

<u>Association and Cooperative Dues</u>: Association and Cooperative dues sometimes include deductible items. E.G. Cooperative Dues usually include your pro-rata portion of interest on the master mortgage, and property taxes. The Association should provide you with a statement for these deductible items.

<u>Cleaning</u>: If you have someone in to clean on a regular basis, and that person is not someone else's employee (agency or cleaning company), you may need to treat them as a "Household Employee." This requires collection and payment of Social Security and Medicare taxes and reporting the employee (and withholding) as part of your annual tax cycle. There are several ways to fulfill this obligation. Ask a tax professional what the best way to approach this is. Ignoring it can be expensive and may jeopardize your appointment to some future President's Cabinet. (LOL)

<u>Maintenance</u>: since early 2013, the IRS has had its own definition of "maintenance." Their definition probably isn't consistent with your intuitive definition. By and large, the Service's definition favors capitalization rather than deduction… which may be a good thing in the long run. Check with a tax professional for more on this topic.

The Tax Code takes a “deductible if mentioned” posture. Anything the Code says is deductible is deductible if you meet the criteria for the deduction. Anything not specifically identified by the Code as deductible is, by default, a non-deductible personal living expense.

Retaining Records of Operation and Ownership

Record Retention, Deductible Items: Preserve evidence of the annual deduction (cancelled checks, electronic payment, statements (Including the lender’s 1098 form) and calculations) for 4 years after the return is filed.

Record Retention, Capitalized Items: Preserve evidence of capitalized items (cancelled check, electronic payment, statements and calculations) for 4 years after the return for the year in which you dispose of the property is filed.

Record Retention, Tax Credit Items: Since these are also potentially relevant to basis determination, treat them the same way you would treat records of capitalized items. Preserve evidence of tax credit items (cancelled check, electronic payment, statements and calculations) for 4 years after the return for the year in which you dispose of the property is filed.

Record Retention, Non-deductible Items: There is no tax based reason to preserve evidence of non-deductible items (cancelled check, electronic payment, statements and calculations). However, keeping them around for a year or two may help resolve disputes that come up between you and your vendors/contractors.

For tax purposes, records can be kept in most of the common electronic forms. A caution, however, today’s technology and file formats probably have about a two to three-year shelf life. Records kept in those formats may not be accessible in fifteen or twenty years when you sell your house. This is one of the few arenas where paper is still king!

What are Deductions Worth?

What is a deduction worth, anyway? (It Depends!)

As we noted above, TCJA threw a monkey wrench into any of the traditional answers. Post-TCJA, the answer may depend as much on where you live as what you deduct.

The only way (Post-TCJA) to determine the impact of your purchase is to simulate returns that reflect both your pre-purchase situation and your post-purchase condition. Ask your tax representative if you need assistance.

When you Sell your Residence

It's finally time to move on. You need (want) a bigger house, a smaller house, more bedrooms, a bigger yard, better schools for the kids,,,

Bad News: The Code taxes realized gains when you sell.[34]

Good News: Some or all the gain may be exempt. The remaining gain is taxed at lower rates than the rate that applies to your "Ordinary Income."

Best of all for Homeowners: If you and/or your spouse own and live in your home for at least two of five years after you buy it (or before you sell it), you can exclude the first $500,000 of gain from your income ($250,000 for singles if you meet the criterion). Scott Free! You never pay tax on it! Ever! Sounds like a good deal. Let's take a closer look.

The Two-Of-Five Test and the Exclusion

The Test: The two-of-five test applies to sales of your primary residence or a home that was your primary residence. To qualify for the benefits of the two-of-five test you must own and occupy (as your primary residence) the residence for two full years during the five years preceding the sale.

The Exclusion: If you satisfy the Two-of-Five rule, you don't pay tax on the first $250,000 of gain that you reap when you sell the residence. If any of your co-owners/co-occupants satisfy the test, they too exclude the first $250,000 of their gain. None of you must do anything except satisfy the test… you don't have to re-invest the funds, join the Peace Corps, do great deeds, or eat bon-bons for a week.[35] If you satisfy the test $250,000 of (otherwise taxable) gain simply vanishes into Tax-Nirvana.

Sounds simple, but it masks a whole lot of complexity and opportunity.

First, when does the five-year period begin and end? We go at this backwards. The test period ends the day title passes from you to a new, unrelated, owner (usually, close of escrow in California). It follows from that: the period begins on that same date five full years before the end date.

That period may include time during which you did not own or occupy the property… it's all part of what makes this interesting and flexible.

Second, we must measure how long you owned the property during that five-year period. This part of the answer is also straightforward in most cases: You owned the property on every day during the test period on which you held title to it.

One thing is obvious from this. If you first acquired title less than two years ago, you cannot possibly satisfy the ownership test. Any gains you reap are taxable.[36]

Third, we need to determine the number of days on which you occupied the property. This is a bit more nebulous. You occupied the residence on any day on which it was your "principal place of residence and

[34] Gain (or loss) is "realized" in any transaction in which title, money, and/or debt instruments change hands between unrelated parties. Usually, realization occurs when escrow closes and title passes to an unrelated new owner.

[35] We've done three, maybe four, of the four options. We suggest the bon-bons.

[36] There are, as always, exceptions – e.g. for military members who miss because of a PCS or deployment. See "*Rescue Me*," below.

domicile." Domicile means, the place where you habitually reside and to which you intend to return. There is, and has been, a great deal of room for interpretation within that definition. But it does present intriguing possibilities:

- ✓ Sleep at your lover's place, take showers at your own? Your place is probably your domicile.
- ✓ Move in with your lover, make occasional trips back to the old manse… Your lover's place is probably your domicile.
- ✓ Live at a different place from your legal spouse… you both may have different domiciles.
- ✓ Spend about equal time in each of three or four places… you may have no domicile.

When ambiguous domicile cases reach court (which they often do because the stakes are high, both in our current context and several others) the courts apply a "facts-and-circumstances" test to determine domicile. They look at (and rank by importance) things like (in no specific order) the address on your driver's license and your voter registration; where you spend the most time; where your children go to school; where you shop, go to church, or socialize; on and on…

Even then, the answer can be equivocal. My personal favorite: The Court apparently resolved one domicile case based on where the DOG spent most of its time.[37] (BTW Fiercely independent creatures, CATS, have no similar probative value. They usually go where the food goes.)

Finally, we need to determine how much gain there is, how much can be excluded, how much is left, and how the residual is taxed. We talk about each of these in subsequent sections.

Some of the test's implications are straightforward, others – not so much. Here are a few examples:

Temporary Absence: Temporary absences (vacations, short work stints, hospitalization) from your domicile don't count against you for the occupancy test. If you intend to return to your primary residence it remains your domicile. (Don't press this generalization too far. A "temporary absence" of more than one year is closely scrutinized, and "mere statements of intent" disregarded.)

Ownership and Occupancy need not overlap: There are many variations:

1) own and occupy the residence for the first two years of the five-year period, rent it out for the last three. Just make sure the sale closes on time!

2) Own and occupy the property continuously for any two year and one day period. Put the property on the market and move to your next property. (the "slow flip" scenario). You can repeat this pattern every two years and one day if you like. Trade up as you go or buy similar property each time and accumulate the proceeds – there is no reinvestment requirement in the current statute.[38] Just make sure the sale doesn't close too early or too late. Both are unmitigated disasters – as we discuss later.

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[37] Money vs. California; Otherwise known as the "Home is where the Hound is" case. Like many domicile cases, Money doesn't directly relate to the Tests or the Exclusion. It is a "nexus" case that determined which state (as between California and Arkansas) got to tax the Moneys' on the gain from sale of their rental property. "Nexus," like the Test and Exclusion, is based on Domicile – in some cases.

[38] Old Internal Revenue Code Section 121 required that you both reinvest and buy-up. The "new" provision (now well over 15 years old) includes no such requirement. However, you may occasionally hear uninformed statements that it does. If you are curious about why the law changed, it had to do with demographics of an aging population.

Neither Ownership nor Occupancy need be continuous: a year here, a year there, and a day somewhere else during the five-year period suffices… Anything that adds up to two years of both occupancy and ownership works.

It isn't hard to concoct a random occupancy scenario that satisfies the ownership test:

- You sometimes see this scenario if there is relationship discord– e.g. marriage, ownership and occupancy, separation with prejudice to the ownership, reconciliation, re-ownership and re-occupancy, repeat severally and rapidly.
- We sometimes see this scenario when we work with (or are part of) family oriented cultures who routinely trade assets among themselves as needed or as the situation demands – quitclaiming merrily with absolute disregard for the poor tax professional who must unravel the chain of events when the property is sold out of the family.[39]

Relationships offer opportunities and pitfalls: The modern, blended, family offers a raft of opportunities and pitfalls.

Classic Example: A (owner of an established residence that has $450,000 of built in gain) marries B (who also owns an established residence that has $450,000 of built in gain).

1. B moves into A's residence.
2. A puts B on A's title. B puts A on B's title.
3. Wait two or more years.
4. Sell A's property.
5. Move into B's residence
6. Wait two or more years.
7. Sell B's property.

What did we accomplish? If A and B sold their interests without all those machinations, each would have excluded $250,000 and paid capital gain tax on $200,000. If both had no other investment income and only a moderate amount of other ordinary income, the joint tax tab comes to $118,400. Add another $15,200 if either, or both, have substantial investment income.[40]

If they follow the scenario, when A & B sell A's house, they both meet both the ownership and occupancy tests on A's house. On a joint return, they exclude the entire $450,000 gain. Two years later, they do the same thing with respect to B's house. Voila – No tax!

You can probably see the planning opportunities this creates as well as spot some of the pitfalls (A and/or B could be hit by a bus in year one of the plan, to name just one).

Now, what if I told you that A and B don't even have to marry and file joint returns to achieve this result? All that is required is for both to have sufficiently large interests in each other's property and to satisfy the ownership and occupancy test on each property before it is sold. Well, that and a whole lot of trust in each other… Finally, what if I told you that A & B could just as easily be A&B+C&D+E+F…

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[39] Tax practitioners sometimes "get even" when they send the bill for one of these Gordian Knot analyses.

[40] Assumes maximum California tax bracket and breaks down as: Federal Capital Gain tax, $80,000; California Capital Gain Tax, $38,400; Federal Net Investment Income Tax, $15,200.

The Exclusion – And the Mechanics

Applying the exclusion is quite simple once you do the math. The math is simple too. The hardest part of the exclusion claim process is: record keeping. You must discipline yourself to keep the relevant paperwork so you can find it when you need it.

Each person who satisfies the two-of-five rule for the property and <u>who has not claimed a residential gain exclusion in the last two years</u> may claim an exclusion – up to $250,000 each. If you file jointly with your spouse, you may exclude up to $500,000, provided <u>neither of you has claimed a residential gain exclusion in the last two years</u>.[41]

The mechanics of claiming the exclusion are straightforward (by income tax standards): "If you receive an informational income-reporting document such as [Form 1099-S] (PDF), *Proceeds From Real Estate Transactions*, you must report the sale of the home, even if the gain from the sale is excludable.[42] You must always report the sale of the home if you cannot exclude all of your capital gain from income. Use [Form 1040, Schedule D] (PDF), *Capital Gains and Losses*, and [Form 8949] (PDF), S*ales and Other Dispositions of Capital Assets*, when required to report the home sale. Refer to [Publication 523] for the details of reporting your sale on your income tax return."[43]

Rescue Me – I Didn't Satisfy Two-of-Five

The two-of-five rule adopted in 1997 is by and large a "bright line provision." If you satisfy the test, you may take the exclusion. If you don't satisfy the test, you get no exclusion. Turmoil in domestic labor and housing markets (the overheated housing markets of the early 2000's and the collapse of both markets in later years) and international affairs (Afghanistan, Iraq) caused more than a few homeowners to bail before they satisfied the two-of five rule. This, in turn, focused more attention on rules to mitigate the bright line test.

Military personnel often retain their interests in a U.S. residence when deployed or when they receive a PCS (hence, not occupying the residence). Extended military deployments, and the effect they have on the occupancy test, prompted Congress to adopt (retroactive) changes to the two-of-five rule in 2012.[44]

If you, or your spouse, is on qualified official extended duty in the Uniformed Services, the Foreign Service, or the intelligence community, you may elect to suspend the five-year test period for up to 10 years. You are on qualified official extended duty if, for more than 90 days or for an indefinite period, you are:

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[41] This restriction sometimes traps unwary flippers. If one of two spouses has claimed the exclusion in the most recent two years, the maximum exclusion is $250,000. If both spouses have claimed the exclusion in the last two years, the maximum exclusion is $0 (yup, zip-o-dee-doo-dah).

[42] IRS no longer has separate forms for reporting taxable and excludable transactions. Use Form 8949 to report the sale. We suggest you report the sale even if (perhaps, especially if) you do not receive a 1099-S and the entire gain qualifies for exclusion. Reporting obviates awkward questions about "where did all that cash come from?" if the IRS or a banker looks closely at you in the future.

[43] IRS Website: http://www.irs.gov/taxtopics/tc701.html

[44] Military Family Tax Relief Act; the Act's provisions are retroactive. If you filed a return on which you were not able to claim the exclusion, you might wish to amend. Cambyses will be happy to help.

[o] 1 (818) 489-4228 [f] 1 (818) 450-0426 Steven@StevenRoyManagement.com

- At a duty station that is at least 50 miles from your main home, or
- Residing under government orders in government housing.

For active duty military, foreign-service, or intelligence personnel who are continuously deployed, this provision converts the occupancy test from a two-of-five rule to a two-of-fifteen rule.

The IRS has also established other "safe harbors". If you fall within one of these safety zones, you are automatically entitled to the appropriate gain exclusion.

Several hardship exceptions grew out of the economic collapse:

Change of Employment: If your new place of employment is at least 50 miles farther from the residence sold than was the former place of employment, and you sell your home to be closer to the new job you can exclude a portion of the gain. For example, if you owned the old home for only one year, you are entitled to exclude half of either the $250,000 or the $500,000 exclusion. Employment is broadly defined as "the commencement of employment with a new employer, the continuation of employment with the same employer, or the commencement or continuation of self-employment."

Health: A proportionate exclusion is also available if a doctor recommends a change of residence for health reasons. According to the IRS, "if the taxpayer's primary reason for the sale is (l) to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury... or (2) to obtain or provide medical or personal care for a qualified individual suffering from a disease, illness or injury" this exception may be invoked.[45] Selling the family home merely because it is beneficial to the general health or well-being of the taxpayer does not fall within the safe harbor.

Unforeseen Circumstances: This exception is not as amorphous as it sounds. The IRS identifies seven events that qualify if they happen to you, your spouse, a co-owner or a member of your household:

1. Death;
2. Being terminated from employment and thus eligible for unemployment compensation;
3. A change in job status that results in the taxpayer being unable to pay the mortgage and reasonable basic living expenses for the taxpayer's household;
4. Divorce or legal separation;
5. Multiple births resulting from the same pregnancy;
6. Involuntary conversion of the property - such as condemnation by a governmental authority, and
7. Destruction of the property because of a man-made disaster, an act or war or terrorism.

The IRS Commissioner may expand these seven items should the need arise - either generally or in response to a situation involving a specific taxpayer.

Computing and Taxing Gain

If you have maintained proper records computing the gain and tax from sale of a residence is a relatively straightforward process:

Computing Gain is a three-step process.

[45] "Qualified individuals" includes family members who need medical assistance away from the principal residence.

First: Determine your Adjusted Sale Price using information that is on the settlement/closing statement you receive when the sale closes.

Sale Contract Price (RESPA Line 1)

Less, Costs of Sale That You Paid (RESPA, Numerous Lines)

Equals, Adjusted Sale Price

The Costs of Sale that reduce the Contract Price are essentially the same as the Costs of Purchase that you capitalized when you purchased the property (see, "*When you Purchase your Residence/Items That Affect Gain When You Sell*"). In California, sellers typically bear the commission expense. Thus, the costs of sale usually exceed the cost of purchase by a wide margin.

Second: Determine your (Adjusted) Basis in the Property. If you have never rented out your property, this calculation relies solely on records that you have kept while you owned the property.

Purchase Contract Price (Purchase Settlement RESPA, Line 1)

Plus, Costs of Purchase That You Paid

Plus, Cost of Improvements, Betterments, Upgrades and Replacements

Plus, Capitalized Operating Expenses

Less, Insurance Proceeds Received with Respect to Replacements, and

Less, Amounts Received for Granting any Easement or Access

Equals, your "Adjusted Basis" in the Property.

If you keep records of Improvements, Betterments, Upgrades, and Replacements as you install them, this is usually not a difficult exercise. If you don't, you must reconstruct them and, invariably, you will not remember all of them. That is why you need to keep records.

Third and Finally:

Adjusted Sale Price

Minus Adjusted Basis

Equals – Gain (or Loss)

To determine your Taxable Gain (if any) determine how much Exclusion you qualify for. Then:

Gain Computed Above

Minus, Exclusion

Equals Taxable Gain {Zero if Exclusion is greater than your Computed Gain}

Several things about Gain (or loss) from the sale of your residence:

- ✓ Report the sale of property even if there is no taxable gain. This avoids uncomfortable-awkward future discussions of "where did all that money in your account come from?" Banks and the IRS are under new constraints that require proof of source for funds[46]… don't let their problem become yours.

- ✓ Taxable Gains computed above will be taxed as Capital Gain (a good thing) and included in income as Net Investment Income subject to the ACA Medicare surcharge (a potentially bad thing).
- ✓ Net Taxable Losses (either before or after taking the Exclusion) are not deductible under current rules. (Since they are Capital Losses, they wouldn't do you much good even if they were deductible.)

Computing After-Tax Cash Flow

Note what isn't part of the gain and tax calculation: Your initial and refinanced loan balances, loan payoff and cash-out have absolutely nothing to do with taxable gain!

Beware: Cash-out refinancing sometimes produces "phantom income:" The cash settlement you receive when you sell a cash-out refinanced property can be less than the gain you report. In extreme cases, cash out may be less than the tax on the gain! This leaves you in the invidious position of paying taxes with money you don't currently possess – after you have sold your most valuable asset. Example:

	Tax Calculation	Cash Calculation
Sale Price	800,000	800,000
Expenses	70,000	70,000
Adjusted Basis	280,000	
Loan Payout		680,000
Pre-tax Cash from Sale		50,000
Gain	450,000	
Exclusion	250,000	
Taxable Gain	200,000	
Tax on Gain (State and Federal)	58,000	58,000
After Tax Cash from Sale		-8,000

The leverage ratio in this scenario is moderate (85% LTV). Imagine what happens if the property is "under water" because it was refinanced (but not improved) in good times and sold later. This is the scenario many homeowners faced in the market crunch. Even Congress recognized this as a crisis – and enacted relief provisions to cover it. Those relief provisions are still in play but are set to expire and may not be re-enacted.

[46] Most of those constraints grew for the PATRIOT Act and various Anti-Money Laundering statutes enacted over the course of several years following 9/11.