Home, the Mother of All Tax Shelters (Part 1 of 2)

You may have heard it said that owning a home is the world's greatest tax shelter. You can deduct mortgage interest and property taxes. And, almost always, you can keep the gains when you sell your home. But in the last few years, Congress and the Internal Revenue Service have made your home potentially an even greater tax shelter than it has ever been -- especially if you use your home for your business.

How long these breaks stay in place is a real question. Many experts believe the tax breaks Congress gave home owners are a big reason why home prices have shot up so much in so many markets across our country. And President Bush's Advisory Panel on Tax Reform thinks we perhaps should limit some of the goodies. But any changes may take a few years to become law. So enjoy while you can. Here are all the deductions and benefits you get when you pay homage to the mortgage gods and go into more debt than your parents earned in their lifetimes. We'll start with the bread-and-butter breaks, and then we'll hit the new wrinkles.

Taxes

First, you get to deduct all the real property taxes you pay on your home. That includes all state or local taxes for the general welfare, as well. That does not count any trash or garbage collection fees, water bills, or homeowner association charges specifically stated and billed. If you're having your mortgage company escrow for the taxes, you get the deduction when your financial institution makes the payment. And, even if you're a tenant shareholder in a co-op apartment building, you get to deduct your share of any property taxes paid.

There's no limit on the number of properties on which you can deduct taxes paid. If you have 10 homes, you can deduct the taxes on all 10. (But watch out: If your deductions are too great, you could be required to use the Alternative Minimum Tax. The AMT is designed to ensure that everyone pays some tax and does so by forcing you to take fewer deductions.)

Interest

Uncle Sam wants to put you in a home. Sorry, that doesn't sound quite right. How about this: Uncle Sam wants to put you in a house? That's better. In any case, our government actually wants to subsidize your home purchase. It does that by making your interest payments tax-deductible. Interest paid on the purchase of your principal residence is deductible. You can even finance additional land adjacent to your home and deduct the interest as qualified residence interest. You can also deduct the interest you pay to buy a second residence or a vacation home. The personal-interest deduction is currently limited to the first $1 million of debt. If you plan to spend more than $1 million for your house, call your accountants.

You can also deduct the interest on as much as $100,000 worth of home-equity debt. As long as your house has the equity and the debt is secured by that equity, the IRS doesn't even care what you do with the borrowed money. You can use it for whatever purposes you want, including paying for education expenses, taking a nice vacation or just having a really great party to celebrate your newfound deductions.

If you're in the 25% bracket, $100 in interest paid only takes $75 out of your pocket. Uncle Sam pays the other $25 in income taxes forgone. Watch this one, however. The President's Tax Panel thinks the interest deduction should be limited, but Congress has not yet weighed in on the topic.

Gain exclusion

Here's where, a few years ago, the Congress and the IRS really gave up the farm.
In the good old days (i.e., before 2002), you had to worry about having to roll over your gain into a new home. Or work to qualify for the $125,000 gain exclusion if you're age 55 or older. The current rule is good no matter how old you are.