Legal Matters®

Real Estate
summer 2012

Buying? Selling? Refinancing?

Know the tax rules!

Owning a home provides a lot of tax advantages. Sometimes, though, the rules can be tricky.

Here's a brief introduction to some of the many tax rules involved in buying, selling, or refinancing a home. But remember, the rules are complicated, and there are always exceptions. You'll want to consult an attorney or tax advisor to see how the general rules apply to your specific situation.

▶ ***If I own a home, can I deduct my mortgage interest payments?***

Yes, home mortgage interest is generally deductible on your federal income tax return on loan amounts up to $1 million. To get the deduction, you'll need to itemize your deductions on Schedule A. For most people, this is the primary tax advantage of owning a home.

Your lender will typically send you a notice at the end of the year telling you how much of your payments were for interest as opposed to principal.

▶ ***Can I deduct my property taxes?***

Yes, in most cases you can deduct your local property taxes on your federal income tax return – again, if you itemize deductions.

Homeowners often pay some money each month as part of their mortgage payment that goes into an escrow account, which the lender then uses to pay property taxes. Note that the amount you can deduct is the amount that's actually paid in taxes – *not* the amount you pay into this account, which might be slightly different.

Some types of property taxes – such as special one-time assessments for sidewalks or sewer lines – might not be deductible. Also, condo fees and homeowners' association fees are not deductible.

▶ ***When I buy a home, can I deduct my closing costs?***

There are a number of different types of closing costs, some of which are deductible

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Another reason to always have a property inspected

A couple who purchased a condo in a building that turned out to be contaminated with toxic chemicals can recover only 65% of their losses, because they could have arranged an environmental inspection of the property before they bought it but didn't do so, the Michigan Court of Appeals recently decided.

The couple bought a condo unit in a converted factory. The developer had installed a vapor barrier, but never actually decontaminated the dangerous chemicals on the site.

The buyers claimed that the seller's real estate agents assured them the site was safe. It appears the agents believed that was true at the time, but when they later found out that the site still had problems, they didn't say anything.

According to the court, the agents could still be liable, because even though they didn't technically lie, they had a legal obligation to tell the buyers about the problems once they knew about them.

On the other hand, the court said the buyers were partly at fault because they never obtained an environmental inspection. The buyers merely relied on the agents' statements, along with a local newspaper article and public "buzz" suggesting that the factory had been cleaned up.

A jury found that the agents were 65% at fault and the buyers were 35% at fault, and the court said this was correct – so the buyers can recover only 65% of what they lost.

A couple who claimed they were misled about a property can't recover all their losses, because they could have discovered the problems by hiring an inspector.

Contractor sues landlord after tenant doesn't pay

If a tenant hires a contractor to make improvements to a property, but the tenant doesn't pay the contractor in full, can the contractor sue the *landlord* for the difference?

It sounds unlikely, but it happened in one case recently.

Former Boston Celtics player Dana Barros leased a warehouse and hired a contractor to make improvements so he could turn it into a sports complex. Later, the contractor believed it hadn't been paid in full, so it went to court against Barros *and* against the owner of the warehouse.

The warehouse owner argued that it couldn't be sued because it was merely the landlord; it never signed an agreement with the contractor.

Most states have what are called "mechanic's liens," such that if a contractor isn't paid in full by someone for work on a property, it can place a lien on the person's interest in the property.

In Massachusetts, the law applies to anyone who hires a contractor, as well as anyone acting on that person's behalf or with that person's "consent."

And in this case, the Massachusetts Supreme Court ruled that Barros had hired the contractor with the "consent" of the landlord.

Although the lease didn't *require* Barros to hire a contractor and make improvements, the court noted that the need for the improvements was obvious, the lease had been structured specifically to entice Barros to make the improvements, and the lease specified that the improvements would belong to the landlord after the lease was up.

Therefore, the court said, the contractor could place a lien not only on Barros's rental interest in the property, but on the landlord's ownership interest as well.

Landlords who are contemplating having tenants make substantial improvements might want to protect themselves against this possibility by requiring the tenant to obtain a bond or place the construction funds in an escrow account.

Buying? Selling? Refinancing? Know the tax rules!

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and some of which are not. For instance, you can generally deduct "points" you pay on a mortgage on your primary residence. Interestingly, you can usually deduct points even if the seller pays them for you – a nice arrangement for a buyer!

On the other hand, there's typically no deduction for other types of closing costs such as appraisals, title insurance, recording fees, or private mortgage insurance.

You might be entitled to a deduction if you pre-pay mortgage interest or a pro-rated amount of property taxes at closing. Buyers who close in the middle of a month often pay these amounts through the end of the current month.

▶ ***If I take out a home equity loan, can I deduct the interest?***

It depends on what you use the money for.

If you use the money for a car, a vacation, college tuition, etc., then you can deduct your interest on loan amounts up to $100,000. If you borrow more than $100,000, the interest on the excess is not deductible.

However, if you use the money to make improvements to your home, then the money is treated for tax purposes as though it's part of your home mortgage … so you can deduct all the interest, along with your mortgage interest, as long as the total amount you've borrowed doesn't exceed $1 million plus $100,000.

There are a few exceptions, however. One is that if you're subject to the alternative minimum tax, then home equity interest can't be deducted when calculating the AMT. Another is that if you're married and you file separately, the relevant amounts are $500,000 and $50,000, not $1 million and $100,000.

Also, if you don't use your home equity loan to improve your home, and at some point you become "upside-down" such that you owe more on your home than its fair market value, then you can no longer deduct interest on the part of the home equity loan that causes your total indebtedness to exceed the value of the home.

▶ ***What happens if I refinance?***

If you refinance, and the amount of your new mortgage is equal to (or less than) the amount you owe on your old mortgage, then the new mortgage is treated the same as the old mortgage – meaning that, generally, the interest is deductible on loan amounts up to $1 million.

If you do a "cash-out" refinancing and you borrow more than you owe on your existing mortgage, then the excess amount is treated the same as a home equity loan.

This is a tax issue that sometimes trips people up. Many people think they can refinance and simply deduct all the interest on the new loan. But if you "cash out" more than $100,000 and you don't use the excess for home improvement, then interest on the excess is not deductible.

Another issue arises if you pay points at refinancing. While points can usually be deducted immediately if you pay them when you first buy a home, the same is not true if you pay points when refinancing. Generally, you have to deduct them over time. So for instance, if you pay $4,000 in points on a 10-year refinancing loan, you can deduct $400/year for each of the next 10 years.

However, there's an exception if part of the loan is used for home improvement. Suppose you do a cash-out refinancing and you use 15% of the loan proceeds for roof repairs. In that case, you could deduct 15% of the points right away, and deduct the remaining 85% over the life of the loan.

(By the way, if you buy a home that's not your principal residence – such as a vacation home – and you pay points at closing, you generally have to deduct those points over the life of the loan as well.)

▶ ***Do I have to pay taxes when I sell my home?***

In theory, if you sell your home for more than you paid for it, you have a capital gain, and you have to pay capital gains tax.

However, in most cases, you don't have to pay taxes on the first $500,000 of capital gain on a home (or $250,000 if you're married and filing separately).

To get this special treatment, you have to have owned the home and lived in it as your primary residence for two years out of the last five years prior to the sale.

Even if you didn't own and live in the home for two full years, you might still be able to exclude some or all of your capital gain; you just won't be eligible for the full $500,000 exception.

Many people think they can refinance and simply deduct all their points and interest payments. But the law is complicated, and sometimes these deductions are limited.

Homeowner's insurance usually won't cover flooding

Just because a property is not in a high-risk area doesn't mean that flooding is impossible.

Many people are surprised to discover that their standard homeowner's insurance policy does not cover them in the event of a flood.

If you want flood insurance, you generally have to buy a separate policy. Typically these policies are sold by private insurers, but are backed by the U.S. Government through the National Flood Insurance Program.

Some federally backed mortgage programs require homeowners to buy flood insurance if they live in a high-risk area. Some private lenders require this as well, and they may require it even if the property is not in a high-risk area.

You should note that just because a property is not in a high-risk area doesn't mean that flooding is impossible. High-risk areas are typically low-lying regions that are subject to storm surges or overflowing rivers, but even property in a very low-risk area can still be flooded due to heavy rainfall, drainage system failures, or a broken water main.

In fact, about 27% of all insurance claims for flooding are brought by property owners who don't live in flood zones.

Some people mistakenly believe that if there's a flood, their losses will be covered through a federal disaster relief program. That's not true. You generally won't get any assistance at all unless the government declares a disaster area, and even then, most government assistance is in the form of low-interest loans, not compensation for losses. You will eventually have to pay back these loans.

The good news is that homeowner's policies often (though not always) cover some other types of water issues, including leaky roofs, plumbing problems, theft or fire triggered by flood damage, and frozen groundwater. On the other hand, such policies typically won't cover sewer back-up, sump-pump failures, or leaking swimming pools, at least without a special endorsement that costs extra.

As always, it's a good idea to review your insurance coverage regularly and make sure that you're adequately covered.

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