

Dear Client:

Congratulations on the purchase of your new home. You are probably aware that you can claim an itemized deduction on your income tax return for the real estate taxes and home mortgage interest you pay. Most other home ownership costs cannot be deducted currently. However, many of these costs will increase your "basis" (i.e. your cost for tax purposes) in the home. If part of your home qualifies as a home office or if you rent out a portion of the house, a higher basis translates into a larger annual depreciation deduction. And a higher basis can save you tax dollars when you sell your home.

The law allows an exclusion from income for part of the gain realized on the sale of one's home. The exclusion limit is \$250,000 (\$500,000 for most married taxpayers). Some commentators feel that the amount of the exclusion makes keeping track of the basis in the home relatively unimportant. Most homes today are sold for less than \$500,000, and even fewer are sold for a gain approaching that amount. However, that reasoning fails to take into account what is likely to happen to property values in the future. If history is any indication, a home that is kept for 20 or 30 years may easily appreciate in value to five or ten times its current value. Under this scenario, a home that costs \$200,000 could be worth well in excess of \$1,000,000 by the time it is sold. Thus, you will want your basis to be as high as possible in order to avoid or reduce the income tax that may result when you eventually sell your home.

To be able to prove the amount of your basis, you must keep accurate records of your purchase price, closing costs and other purchase expenses, and any later expenses that increase your basis. Save receipts and other records for all improvements and additions you make to your home. Since this process is likely to continue for a long period, you should keep these documents together in a folder or binder together with a summary list from which you can easily determine your basis at any time. When you eventually sell your home, your basis will establish the amount of your gain. The supporting documentation should be kept for at least three years after you file your return for the sale year.

The principal element in the basis of your home is the purchase price. This includes your down payment and any debt, such as a bank mortgage or notes you gave to the seller in payment for the property. It also includes certain settlement or closing costs. If you contracted to have your house built on land you own, your basis is the cost of the land plus the amount it cost you to complete the house. This includes the cost of labor and materials, or the amounts paid to the contractor, and any architect's fees, building permit charges, utility meter and connection charges, and legal fees directly connected with building your home. If you built all or part of your house yourself, basis includes the total amount it cost you to complete it. Basis doesn't include the value of your own labor, or any other labor you didn't pay for. However, if the value of your home increases because of unpaid labor including your own, any such increase that is realized when you sell your home may be eligible for the exclusion (assuming that you otherwise meet the requirements for the exclusion).

You add to the cost of your home certain expenses that you paid in connection with the purchase. These items include:

- ... attorney's fees,
- ... abstract fees and owner's title insurance, and
- ... recording fees and transfer taxes.

However, the following settlement fees or closing costs cannot be added to your basis:

- ... fire insurance premiums,

- ... rent or charges for utilities or other services relating to your occupancy of the house before closing, and
- ... charges connected with obtaining your mortgage, such as credit and appraisal reports, and FHA insurance.

The basis of your home is increased by special assessments for local improvements, and amounts spent after a casualty to restore damaged property. If you sold a previous home and were able to defer recognition (reporting) of the gain under the rules that applied to a sale or exchange of a principal residence before May 7, 1997, the amount deferred reduces your basis in the new home. The basis of your home is also decreased by:

- ... depreciation allowed or allowable if you used your home for business or rental purposes,
- ... insurance reimbursements for casualty losses, as well as deductible casualty losses not covered by insurance,
- ... payments received for an easement or right-of-way that you grant, and
- ... any energy conservation subsidy excluded from your gross income.

Chances are that over time you will make various additions and improvements to your home. You can add the cost of these improvements to your basis. Typical improvements that add to your home's basis include:

- ... adding another room (for example, a den, bathroom or bedroom, or a patio, deck or garage to your home);
- ... finishing your basement;
- ... new landscaping, sprinkler system, and fences;
- ... putting in a new heating or central air conditioning system;
- ... putting on a new roof or installing new plumbing or wiring;
- ... putting in storm windows or doors, security system, central vacuum, or satellite TV dish;
- ... putting in flooring or wall-to-wall carpeting; and
- ... paving your driveway.

Amounts you spend on your home that do not add much to either the value or the life of the property, but rather keep the property in good condition, are considered repairs, not improvements, and you can't add them to the basis of your property. Repairs include interior or exterior repainting, fixing gutters or floors, repairing leaks or plastering, and replacing broken window panes. However, an entire job is considered an improvement if items that would otherwise be considered repairs are done as part of extensive remodeling or restoration of your home.

The cost of appliances you purchase for your home generally don't add to your basis unless the appliance is considered attached to the house. Thus, the cost of a built-in oven or range would increase basis. But an appliance that can be easily removed, such as a television set or home entertainment center, would not.

If you have any questions or would like to discuss this matter further, please call.

Very truly yours,