SALES MEETING TOOL KIT: Part 10
REAL ESTATE TAXES 101

SALES MEETING TOOL KIT:
REAL ESTATE TAXES 101

Federal tax laws give very favorable treatment to homeownership and offer a wide variety of tax deductions to make ownership more affordable and attractive to U.S. citizens. Perhaps it is for this reasons that homeownership in the United States is now 67.5 percent, its highest level ever.

No one expects a real estate salesperson to be a tax expert, but being able to explain the basics of taxes for residential properties offers a service to clients and customers and provides a valuable tool in convincing prospects of the value of real estate ownership.

Use this tool kit—including ready to go agenda, activities, and talking points—to help improve your salespeople's understanding of the basic federal tax laws that apply to residential real estate and how those laws can benefit their buyer and seller clients.

Each component of this tool kit (worksheets, notes) is numbered at the top of the page so you can easily move through the content chronologically.

SALES MEETING TOOL KIT:
REAL ESTATE TAXES 101

Component 1: Facilitator Talking Points

These notes will guide you and your salespeople through a discussion and activities on the basics of federal taxes that affect residential real estate.

Pre-meeting preparation

- Review all the meeting documents in this kit
- Remind participants to bring calculators to the meetings to use in Activities 2 and 3.

Print the following:

1. These facilitator talking points—Component 1

2. Real Estate Taxes 101 Agenda—Component 2

3. Activity 1: Common Real Estate Tax Mistakes Quiz—Component 3

4. Activity 1: Real Estate Tax Mistakes Answer Sheet—Component 4

5. Handout 1: What Can You Deduct When You Own A Home?—Component 5

6. Activity 2: What Tax Deductions Mean to the Homeowner—Component 6

7. Handout 2: What's Your Real Gain?—Component 7

8. Handout 3: A Basis Worksheet —Component 8

9. Handout 4: Improvement vs. Repair—Component 9

10. Activity 3: Name That Tax (A Calculation Contest)—Component 10

11. Activity 3: Name That Tax Answer Sheet—Component 11

12. Other Resources—Component 12

SALES MEETING TOOL KIT:
REAL ESTATE TAXES 101

Component 1: continued

Welcome (1 minute)

Background, objectives, and goals (2 min.)
Explain that federal tax policies that offer deductions for common homeownership expenses such as property taxes and mortgage interest make homeownership more affordable and attractive to U.S. citizens. Although tax benefits are almost certainly not the main reason people buy homes, they play an important part in the stability and strength of the U.S. real estate market.

In this meeting, we will:

- Talk about the principal expenses deduction that clients will usually qualify for when they buy or sell a home.
- Review the meaning of cost basis and why it is important.
- Talk about some of the expenditures that can be used to increase or decrease an owner's cost basis in a home and what records a homeowner must have to support these adjustments.
- Practice calculating the allowable expenses and adjustments to basis that will commonly occur in residential sales transactions.

Note to facilitator: Throughout the meeting, emphasize the importance of encouraging clients to seek professional help in calculating their tax liabilities.

Activity 1: Common Real Estate Tax Mistakes Quiz (5 min.)
Let participants take this brief quiz (Component 3) to see how up to date they are on taxes affecting homeownership. Use the Answer Sheet (Component 4) to review the answers and determine what tax areas participants understand. Emphasize the changes in the federal capital-gains tax laws that took effect in 1997—particularly the introduction of the $250,000 gains exclusion. Point out how much more affordable it is now for consumers to buy and sell real estate more frequently.

Handout 1: What Can You Deduct When You Own A Home? (10 min.)
Review some of the major costs associated with acquiring, owning, and selling a home, and how each is treated for tax purposes. Use a flip chart to create a checklist that participants can give to buyers and sellers about common real estate deductions. Point out when vacation homes sometimes qualify for these deductions. (Be sure to have your list reviewed by the company's accountant before distributing it to clients.)

SALES MEETING TOOL KIT:
REAL ESTATE TAXES 101

Component 1: continued

Activity 2: What Tax Deductions Mean to the Homeowner (5 min.)
Use the example in this handout to teach participants a simple calculation that they can use with their clients to demonstrate the value of homeownership. Next, ask participants to do their own calculation of tax savings using the second example. The correct answer to this question is $9,482 of total expenses, resulting in a savings of $2,560.95 ($9,482 X .27).

Handout 2: What's Your Real Gain? (5 min.)
Review the basics of how capital gains are calculated for real estate. Although the current exclusion of $250,000 for individuals and $500,000 for married couples filing jointly means that many homeowners are exempt from capital-gains liability, capital gains may still impact some older individuals who have owned their homes for a long time or owners who resell their homes in less than two years.

Handout 3: A Basis Worksheet (5 min.)
Use Handout 3 to help participants understand what costs the buyer and the seller may apply to increase or decrease their cost basis. Review the difference between a capital improvement, which materially adds value or extends useful life, and a repair.

Handout 4: Improvement vs. Repair (5 min.)
Distribute Handout 4: Improvement vs. Repair (Component 9) and use it to help participants develop lists of items that would be considered capital improvements (and thus added to the base cost of a home for tax purposes). Write additional items on a flip chart divided into two columns and have participants write them in the spaces on Handout 4.

Activity 3: Name That Tax (10 min.)
Hand out copies of three tax calculations scenarios (Component 10), and let participants calculate the answers to each set of questions. Offer a small prize, such as a $5 lunch coupon, to the participant who calculates the correct answer to each scenario the fastest. Use the Name That Tax Answer Sheet (Component 11) to prompt the right answers.

Adjourn.
Thank participants for attending.

SALES MEETING TOOL KIT:
REAL ESTATE TAXES 101

Component 2: Real Estate Taxes 101 Meeting Agenda

Welcome (1 minute)

Background, objectives, and goals (2 min.)
To help sales associates gain a basic understanding of taxes affecting homeownership so that they can use these tax benefits as a sales tool.

Activity 1: Common Real Estate Tax Mistakes Quiz (5 min.)
Take this quick quiz to test your tax savvy.

Handout 1: What Can You Deduct When You Own A Home (10 min?) Review the major deductions buyers and sellers are eligible for in a residential transaction and learn how to demonstrate the impact of these deductions on homeowners' tax liability.

Activity 2: What Tax Deductions Mean to the Homeowner (5 min.)
Work through a quick demonstration for buyers on the tax advantages of homeownership.

Handout 2: What's Your Real Gain? (5 min.)
Learn what factors go into calculating the capital gains on a sale.

Handout 3: A Basis Worksheet (5 min.)
Review how costs of ownership may be used to adjust the homeowners' cost basis in a home.

Handout 4: Improvement vs. Repair (5 min.)
Recognize the difference between an improvement and a repair.

Activity 3: Name That Tax Contest (10 min.)
See how fast your fingers can fly as you compete to calculate gains and expenses in these sample scenarios.

Adjourn.

Running time: 48 minutes

SALES MEETING TOOL KIT:
REAL ESTATE TAXES 101

Component 3 : Activity 1, Common Real Estate Tax Mistakes Quiz

1. A seller must buy another home within eighteen months of the sale of a principal residence to avoid paying taxes on gains.

T F

2. You don't have to live in your home at the time it is sold to qualify for the capital-gains exclusion.

T F

3. A seller must be over 55 years of age to qualify for an exclusion of capital gains on the sale of a home.

T F

4. An owner can deduct the mortgage interest for two residences at a time.

T F

5. A homeowner may deduct all money spent on improving a home as expenses in the year the money was spent.

T F

SALES MEETING TOOL KIT:
REAL ESTATE TAXES 101

Component 4: Answer Sheet for Activity 1, Real Estate Tax Mistakes

1. A seller must buy another home within eighteen months years of the sale to avoid paying taxes on profits from the sale of a principal residence.

False. Before the passage of tax reform in 1997, homeowners had to reinvest the gains from the sale of their principal residence within 18 months to delay tax liability. Today, homeowners don't have to reinvest in real estate to avoid tax on capital gains; they may use the proceeds in any way they choose.

2. A homeowner doesn't have to live in a home at the time it is sold to qualify for the capital-gains exclusion.

True. A homeowner must have lived in the home as a principal resident for two years out of the five years preceding the sale to qualify for the capital gains exemptions. But those two years do not have to be immediately prior to the sale.

3. A seller must be over 55 years of age to qualify for an exclusion of capital gains on the sale of a home.

False. Before 1997, only homeowners aged 55 and older were eligible to exclude capital gains from their homes from taxation. The exclusion was a one-time exclusion of a gain up to $125,000. Today, a homeowner of any age may be eligible for an exclusion of capital gains once every two years.

4. An owner can deduct the mortgage interest for two residences at a time.

True. Mortgage interest and real estate taxes paid on a principal residence and a second home that isn't rented more than a certain number of days a year can be deducted by taxpayers. However, only two homes may qualify for the deduction at any one time and the total amount of the two mortgages cannot exceed $1 million.

5. A homeowner may deduct all money spent on improving a home as expenses in the year the money was spent.

False. Money spent on capital improvements to a residence may usually be added to the basis of the home, thereby lowering the realized capital gain when the home is sold. However, expenses may not be deducted against income unless the property is an investment property or the money was spent specifically to make the home ready for sale.

SALES MEETING TOOL KIT:
REAL ESTATE TAXES 101

Component 5: Handout 1, What Can You Deduct When You Own a Home?

For tax purposes, deductions for residential real estate held for personal use generally fall into two main categories:

- costs that can be deducted as expenses from a buyer's or seller's personal income on a tax return
- costs that can be used to alter the basis of the home, with the idea of lowering the capital gains

Note that a second, or vacation, home generally qualifies for all of the same deductions as a principal residence provided that it isn't rented for a significant portion of the year.

Buyers may deduct the following items associated with buying a home as expenses on their personal income tax in the year that they buy the home.

Points—including loan origination fees and loan discounts, provided that the home is your principal residence, the amount is clearly stated on the settlement statement, and the purchase meets the nine criteria for deducting points established by the IRS. (See www.irs.gov/prod/forms_pubs/pubs/p53001.htm for details on these criteria.)

If the buyer doesn't satisfy all of these criteria, points must be prorated and deducted over the life of the mortgage.

Buyers may add the following costs associated with a purchase to the basis of their home. These additions will increase the basis and serve to lower the capital gains liability when the home is eventually sold:

1. Transfer or stamp taxes and recording fees, if paid by the buyer.

2. Title abstracts.

3. Title insurance.

4. Attorney's fees for preparing their documents for closing.

SALES MEETING TOOL KIT:
REAL ESTATE TAXES 101

Component 5: continued

Buyers **cannot** deduct as expenses on their income tax or add to the cost basis of the home:

1. Fees for an appraisal required by the lender.
2. Rent paid to occupy the home before closing.
3. Cost of credit reports.
4. Loan assumption fees.

During the period of homeownership, owners of single-family homes, condominiums, coops, and other types of property occupied as a principal residence may deduct the following items as expenses each year on their income tax returns:

1. Interest paid on a mortgage loan(s) of $1 million or less taken out to buy, build, or improve a home. If the loan amounts you owe on your first and second home together exceed $1 million, not all interest is deductible. Note that married couples filing separately may each deduct interest on a total mortgage debt of $500,000.

2. Late payment charges on mortgage payments

3. Real estate taxes paid on the home in the year they are paid

Homeowners may not deduct:

1. Homeowners association dues or assessments.

2. Premiums for fire or homeowners' insurance. (Note that this is often included in the monthly house payment.)

At the time of the sale, the sellers may deduct the following expenses from their income taxes:

1. Any reserved real estate taxes credited to the buyer at closing. However, these deductions can't be taken until the year that the property taxes are actually paid to the taxing body.

2. Any mortgage interest paid for the portion of the year that the house was owned.

3. Any remaining, undeducted points for the satisfied mortgage.

SALES MEETING TOOL KIT:
REAL ESTATE TAXES 101

Component 5: continued

In calculating the capital gains resulting from a sale, the sellers may add the costs following items to their existing basis:

1. Transfer or stamp taxes and recording fees, if paid by the seller.

2. Recording fees, if paid by the seller.

3. Attorney's fees for preparing their documents for closing.

4. Real estate commissions paid to a broker and sales associates.

5. Money spent to repair the house prior to sale, if spent within 90 days of the sale.

Tax laws can change frequently. Always consult an accountant or tax attorney if you have questions on real estate tax issues.

SALES MEETING TOOL KIT:
REAL ESTATE TAXES 101

Component 6: Activity 2, What Tax Deductions Mean to the Homeowner

You can help buyers understand the tax benefits of homeownership by demonstrating how annual tax deductions for mortgage interest and property taxes will reduce their income tax liability.

Assume:

Mortgage interest paid (a loan of $150,000 for 30 years, at 7 percent, using year-five interest)	$9,877
Taxes (at 1.5 percent on $180,000 assessed value)	2,700
Total deduction	$12,577
Amount you have lowered your federal income tax (at 27 percent tax rate)	$3,395.79

Assume:

Mortgage interest paid (a loan of $125,000 at 6.75 percent, using year-five interest)	$6,482
Taxes (at 2 percent on a $150,000 assessed value)	3,000
Total deduction	_____
Amount you have lowered your federal tax (at 27 percent tax rate)	_____

See Facilitator Notes, under Activity 2, for answer.

SALES MEETING TOOL KIT:
REAL ESTATE TAXES 101

Component 7: Handout 2, What's Your Real Gain?

Capital Gains Facts

· Capital gains are the net profits realized from the sale of any investment held for more than 12 months. A principal residence, which can be a single-family home, a condominium, a cooperative, or a manufactured home, is treated as a capital asset. The capital gains rate is currently 20 percent. The capital gains rate for properties acquired after 2000 and held for five years or more is 18 percent.

· Since 1997, homeowners may exclude the first $250,000 in gain ($500,000 if married and filing jointly) on the sale of one home every two years. To qualify for this exemption, homeowners must have lived in the home as their principal residence for two out of the last five years. Note that the 24 months don't have to be consecutive to qualify.

Calculating Capital Gains

1. Take the contract sale price of the home

2. Subtract:

· The amount paid for the home

· Any adjustments to the sale price (See Handout 3)

3. The result is the net capital gains realized on the sale

SALES MEETING TOOL KIT:
REAL ESTATE TAXES 101

Component 8: Handout 3, A Basis Worksheet

To calculate capital gains, you must know the total cost or adjusted cost basis of your home.

The cost basis is:
- the amount you paid for the home
- the cost of the land and the cost of building your home
- the amount you paid for your cooperative share, if your home is a coop
- the fair market value of the home as of the date you inherited it

Your basis can also be increased or decreased by any allowable "adjustment to the basis" that you have made. The higher the basis is the lower the gain will be, and therefore, the lower the potential tax liability.

Common adjustments that increase your basis:

1. Capital improvements are any expenditure that
- materially adds value
- will last more than 12 months
- creates a new use

Capital improvements include items such as a renovation of all or part of the house; adding new rooms; adding new roof, a fence, or a pool; paving your driveway; or putting in new plumbing, wiring, or appliances. (Note that if you do any work yourself, the cost of your labor can't be added to the basis.)

Keep in mind that the costs of repairs—including painting inside or out, fixing gutters or leaks, replastering, and replacing a broken window—are not considered capital improvements unless they are done as part of a major renovation.

Common adjustments that reduce your basis:

1. Energy conservation subsidies received from a utility

2. Depreciation you deduct from your income taxes on the portion of your home you use as a home office

SALES MEETING TOOL KIT:
REAL ESTATE TAXES 101

Component 8: continued

In addition, certain costs associated with the buy-sell transaction may be added to the basis.

For the buyers, these include:

1. Recording fees

2. Buyers' attorney fees associated with the closing

3. Inspection fees, if the buyers pay them

For the sellers, these include:

1. Transfer taxes and stamp fees

2. Sellers' attorney fees associated with the transaction

3. Real estate commission

SALES MEETING TOOL KIT:
REAL ESTATE TAXES 101

Component 9: Handout 4, Improvement vs. Repair

Improvements	**Repairs**
Garbage disposal	Interior painting
Wall to wall carpeting	Repair/patch worn carpeting
Install built-in storage units	Refinish wood floors
Add storm windows	Replace one cracked window
Add pet run	Replace belt on furnace
Install burglar alarm system	

Remind participants that owners may continue to add capital improvements to the basis for as long as they live in the house; there is no time limit. However, they must keep records of dates, vendors, and amount actually spent to support their claims.

SALES MEETING TOOL KIT:
REAL ESTATE TAXES 101

Component 10: Activity 3, Name That Tax, or How Fast Can You Calculate

Calculate the answers to the tax questions buyers and sellers might ask in each scenario.

Scenario 1: Bob and Sally Reiner bought their home five years ago for $125,000 and spent $1,200 in closing costs and $1,250 in points to acquire their loan. Their annual real estate taxes are $1,000 a year and they pay a yearly fee of $50 to the homeowners association. During the time they have lived there, the couple has added a stone patio to the back of the house ($1,200), painted the exterior of the house ($850), and put a new roof on the house ($2,000). They also installed a new furnace ($1,800), which entitled them to a $200 energy conservation rebate from their utility. They have just sold the house to the Levinsons for $158,000 and paid a commission of $9,480. The Reiners paid their attorney $350 to prepare documents for closing and paid $1,300 in recording fees and transfer taxes. They used $96,000 of the money they received to pay off their existing mortgage.

a. What is the Reiners' basis in their home at the time of sale?

b. What capital gains did the Reiners realize on the house?

c. What are the Reiners tax liabilities on this capital gain?

Scenario 2: Blanche and Tom Williams bought a home in April 2000 and are now getting the records together to pay their 2000 income tax. In buying the house, the Williams's spent $2,000 on points (which they will take as a single deduction), $500 on attorney's fees for the closing, $125 for title insurance, and $250 for an appraisal required by their lender. They spent $600 on a new water heater and had two rooms repainted for $200. During their first partial year of ownership, they paid $5,000 in mortgage interest, plus one late fee of $75, and deposited $1500 in their tax escrow account. On their behalf, the bank made the first tax payment due in January 2001 of $1,020.

a. How much in expense deductions are the Williams entitled to on their 2000 federal tax return?

b. What costs item can they add to the basis of their home?

SALES MEETING TOOL KIT:
REAL ESTATE TAXES 101

Component 10: continued

Scenario 3: John and Marcia Houser bought their home 30 years ago for $25,000. Fifteen years ago, the couple did a major renovation of the house, which cost a total of $35,000. Since they are now over 65 and retired, the Housers haven't done much to keep their house up, although they did repave their driveway two years ago ($1,000) and install air conditioning ($1,500).

When they listed their home with Jeff Vesos, he suggests repainting the house inside and out ($1,400), adding new landscaping ($900), and replacing the carpeting on the first floor ($2,300). Jeff's strategy proved correct; just 55 days after the work was completed, the Housers closed on a sale and receive $350,000 for their home. Jeff received a commission of $17,500. The Housers paid other closing costs—attorney's fees and recording fees of $3,600.

a. What is the Housers basis in their home?

b. What were their capital gains on the sale?

c. What are their tax liabilities for the sale?

SALES MEETING TOOL KIT:
REAL ESTATE TAXES 101

Component 11: Answers for Activity 3, Name That Tax, or How Fast Can You Calculate

Use these calculations to help participants arrive at the right answers to each scenario.

Scenario 1
a. What is the Reiners' basis in their home at the time of sale?

Initial purchase price of home:	$125,000
	1,200
PLUS	
Additions to basis	
Patio (capital improvement)	1,200
New roof (capital improvement)	2,000
New furnace (capital improvement)	1,800
Real estate commission	9,480
Attorney's fee for closing	350
Recording fees	1,300
MINUS	
Reductions to basis	
Energy rebate from utility	200
Adjusted basis at time of sale	$140,930

Possible errors: The exterior painting is a repair; only capital improvements may be factored into the basis. Property taxes and mortgage payments may be deducted as expenses, but do not apply to basis.

b. What capital gains did the Reiners realize on the house?

Sale price of house	$158,000
MINUS	
Adjusted basis at time of sale	$140,930
Capital gain	$ 17,070

SALES MEETING TOOL KIT:
REAL ESTATE TAXES 101

Component 11: continued

c. What are the Reiners tax liabilities on this capital gain?

Because they have owned and lived in the property for more than two years, the Reiners are entitled to a capital gains exemption of $500,000 (for a married couple). They have no tax liability.

Scenario 2:

a. How much in expense deductions are the Williams entitled to on their 2000 federal tax return?

Mortgage interest	$5,000
Mortgage late fee	75
Points	2,000
Total deductions	$7,075

Although real estate taxes can be deducted as expenses for income tax purposes, they cannot be deducted until the year they are actually paid. Since taxes were not paid until 2001, the Williams are not eligible to deduct the amounts they deposited.

b. Based on this scenario, how much can the Williams add to the basis of their home?

Attorney's fees	$500
Title insurance	125
Water heater	600
Total additions to basis	$1,225

Possible error: Neither the appraisal fee nor the painting qualify as either an expense or an addition to basis.

SALES MEETING TOOL KIT:
REAL ESTATE TAXES 101

Component 11: continued

Scenario 3

a. What is the Housers basis in their home?

Initial purchase of house	$25,000
PLUS	
Additions to basis	
Major renovation	35,000
Pave driveway	1,000
Air conditioning	1,500
Real estate commission	17,500
Closing costs	3,600
*Repaint house	1,400
Landscaping	900
Carpet replacement	2,300
Total adjusted basis:	$88,200

*This item may be added to basis because the work was done within 90 days of the sale.

b. What were their capital gains on the sale?

Sale price of house	$350,000
MINUS	88,200
Capital gains realized	$261,800

c. What are their tax liabilities for the sale?

None. Because the Housers are a married couple filing joint, their combined capital-gains exclusion is $500,000. If the house were owned by only one person, the exemption would be only $250,000 and the owner would owe capital-gains taxes on $11,800

SALES MEETING TOOL KIT:
REAL ESTATE TAXES 101

Component 12: Other Resources

Visit REALTOR.org and search for "taxes." Also, you'll find a complete summary of the current treatment of capital gains for residential real estate sales under the 1997 Tax Relief Act.

Visit the Internal Revenue Service's site, and use its search feature to find information and updates on tax issues. Publication 523 is particularly helpful.

Visit the "Buying a House" section at nolo, a free site with legal advice.

Visit www.cpaonline.com for a directory of tax resources.

The following articles on taxation are available here, at *Realtormag.com*:

"Tax Tools: Software," Christina Hoffmann Spira, *REALTOR® Magazine*, February 1999.

"Managing Your Money: A Profitable Exchange," Robert Sharoff, *REALTOR Magazine*, September 2000.

"Buyer's Guide Plus: Number Crunchers," Michael Antoniak, *REALTOR Magazine*, May 2000.