Publication 530
Cat. No. 15058K

Tax Information for First-Time Homeowners

For use in preparing 2004 Returns

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What’s New

General sales tax deduction. You can elect to deduct state and local general sales taxes instead of state and local income taxes as an itemized deduction on Schedule A (Form 1040). Deductible sales taxes may include sales taxes paid on a home. For more information, see Sales Taxes.

Reminders

Limit on itemized deductions. Certain itemized deductions (including taxes and home mortgage interest) are limited if your adjusted gross income is more than $142,700 ($71,350 if you are married filing separately). For more information, see the instructions for Schedule A (Form 1040).

Photographs of missing children. The Internal Revenue Service is a proud partner with the National Center for Missing and Exploited Children. Photographs of missing children selected by the Center may appear in this publication on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling 1-800-THE-LOST (1-800-843-5678) if you recognize a child.

Introduction

This publication provides tax information for first-time homeowners. Your first home may be a house, condominium, cooperative apartment, mobile home, houseboat, or house trailer. The following topics are explained.

• How you treat items such as settlement and closing costs, real estate taxes, sales taxes, home mortgage interest, and repairs.
• What you can and cannot deduct on your tax return.

Get forms and other information faster and easier by:
Internet • www.irs.gov
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What You Can and Cannot Deduct

To deduct expenses of owning a home, you must file Form 1040 and itemize your deductions on Schedule A (Form 1040). If you itemize, you cannot take the standard deduction. See the Form 1040 instructions if you have questions about whether to itemize your deductions or claim the standard deduction.

This section explains what expenses you can deduct as a homeowner. It also points out expenses that you cannot deduct. There are two primary discussions: taxes and home mortgage interest. Generally, your real estate taxes and home mortgage interest are included in your house payment.

Your house payment. If you took out a mortgage loan to finance the purchase of your home, you probably have to make monthly house payments. Your house payment may include several costs of owning a home. The only costs you can deduct are real estate taxes actually paid to the taxing authority and interest that qualifies as home mortgage interest. These are discussed in more detail later.

Here are some expenses, which may be included in your house payment, that cannot be deducted.

- Fire or homeowner’s insurance premiums.
- FHA or other mortgage insurance premiums.
- The amount applied to reduce the principal of the mortgage.
- Depreciation.

Basis of Assets

Business Use of Your Home

Minister’s or military housing allowance. If you are a minister or a member of the uniformed services and receive a housing allowance that is not taxable, you still can deduct your real estate taxes and your home mortgage interest. You do not have to reduce your deductions by your nontaxable allowance.

Nondeductible payments. You cannot deduct any of the following items.

- Insurance, including fire and comprehensive coverage, and title and mortgage insurance.
- Wages you pay for domestic help.
- Depreciation.
- The cost of utilities, such as gas, electricity, or water.

Most settlement costs. See Settlement or closing costs under Cost as Basis, later, for more information.

Real Estate Taxes

Most state and local governments charge an annual tax on the value of real property. This is called a real estate tax. You can deduct the tax if it is based on the assessed value of the real property and the taxing authority charges a uniform rate on all property in its jurisdiction. The tax must be for the use of the general public and not be a payment for a special privilege granted or service rendered to you.

Deductible Real Estate Taxes

You can deduct real estate taxes imposed on you. You must have paid them either at settlement or closing, or to a taxing authority (either directly or through an escrow account) during the year. If you own a cooperative apartment, see Special Rules for Cooperatives, later.

Where to deduct real estate taxes. Enter the amount of your deductible real estate taxes on Schedule A (Form 1040), line 6.

Real estate taxes paid at settlement or closing. Real estate taxes are generally divided so that you and the seller each pay taxes for the part of the property tax year you owned the home. Your share of these taxes is fully deductible, if you itemize your deductions.

Division of real estate taxes. For federal income tax purposes, the seller is treated as paying the property taxes up to, but not including, the date of sale. You (the buyer) are treated as paying the taxes beginning with the date of sale. This applies regardless of the lien dates under local law. Generally, this information is included on the settlement statement you get at closing.

You and the seller each are considered to have paid your own share of the taxes, even if one or the other paid the entire amount. You each can deduct your own share, if you itemize deductions, for the year the property is sold.

Example. You bought your home on September 1, the property tax year (the period to which the tax relates) in your area is the calendar year. The tax for the year was $730 and was paid by the seller on August 15.

You owned your new home during the property tax year for 122 days (September 1 to December 31, including your date of purchase). You figure your deduction for real estate taxes on your home as follows.

1. Enter the total real estate taxes for the real property tax year. 
   - Enter the number of days in the property tax year that you owned the property. 
   - Multiply line 2 by line 3. This is your deduction. Enter it on Schedule A (Form 1040), line 6.

   $243

You can deduct $243 on your return for the year if you itemize your deductions. You are considered to have paid this amount and can deduct it on your return even if, under the contract, you did not have to reimburse the seller.

Dedelinquent taxes. Delinquent taxes are unpaid taxes that were imposed on the seller for an

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earlier tax year. If you agree to pay delinquent taxes when you buy your home, you cannot deduct them. You treat them as part of the cost of your home. See Real estate taxes, later, under Cost as Basis. Escrow accounts. Monthly house payments include an amount placed in escrow (put in the care of a third party) for real estate taxes. You may not be able to deduct the total you pay into the escrow account. You can deduct only the real estate taxes that the lender actually paid from escrow to the taxing authority. Your real estate tax bill will show this amount. Refund or rebate of real estate taxes. If you receive a refund or rebate of real estate taxes this year for amounts you paid this year, you must reduce your real estate tax deduction by the amount refunded to you. If the refund or rebate was for real estate taxes paid for a prior year, you may have to include some or all of the refund in your income. For more information, see Publication 525, Taxable and Nontaxable Income.

Items You Cannot Deduct as Real Estate Taxes

The following items are not deductible as real estate taxes.

Charges for services. An itemized charge for services to specific property or people is not a tax, even if the charge is paid to the taxing authority. You cannot deduct the charge as a real estate tax if it is:

- A unit fee for the delivery of a service (such as a $5 fee charged for every 1,000 gallons of water you use),
- A periodic charge for a residential service (such as a $20 per month or $240 annual fee for garbage collection), or
- A flat fee charged for a single service provided by your local government (such as a $30 charge for mowing your lawn because it had grown higher than permitted under a local ordinance).

You must look at your real estate tax bill to decide if any nondeductible itemized charges, such as those listed above, are included in the bill. If your taxing authority (or lender) does not furnish you a copy of your real estate tax bill, ask for it.

Assessments for local benefits. You cannot deduct amounts you pay for local benefits that tend to increase the value of your property. Local benefits include the construction of streets, sidewalks, or water and sewer systems. You must add these amounts to the basis of your property.

You can, however, deduct assessments (or taxes) for local benefits if they are for maintenance, repair, or interest charges related to those benefits. An example is a charge to repair an existing sidewalk and any interest included in that charge. If only a part of the assessment is for maintenance, repair, or interest charges, you must be able to show the amount of that part to claim the deduction. If you cannot show what part of the assessment is for maintenance, repair, or interest charges, you cannot deduct any of it.

An assessment for a local benefit may be listed as an item in your real estate tax bill. If so, use the rules in this section to find how much of it, if any, you can deduct.

Transfer taxes (or stamp taxes). You cannot deduct transfer taxes and similar taxes and charges on the sale of a personal home. If you are the buyer and you pay them, include them in the cost basis of the property. If you are the seller and you pay them, they are expenses of the sale and reduce the amount realized on the sale.

Homeowners association assessments. You cannot deduct these assessments because the homeowners association, rather than a state or local government, imposes them.

Special Rules for Cooperatives

If you own a cooperative apartment, some special rules apply to you, though you generally receive the same tax treatment as other homeowners. As an owner of a cooperative, you own shares of stock in a corporation that owns or leases housing facilities. You can deduct your share of the corporation’s deductible real estate taxes if the cooperative housing corporation meets all of the following conditions:

- The corporation has only one class of stock outstanding,
- Each stockholder, solely because of ownership of the stock, can live in a house, apartment, or house trailer owned or leased by the corporation,
- No stockholder can receive any distribution out of capital, except on a partial or complete liquidation of the corporation,
- The tenant-stockholders pay at least 80% of the corporation’s gross income for the tax year. For this purpose, gross income means all income received during the entire tax year, including any received before the corporation changed to cooperative ownership.

Tenant-stockholders. A tenant-stockholder can be any entity (such as a corporation, trust, estate, partnership, or association) as well as an individual. The tenant-stockholder does not have to live in any of the cooperative’s dwelling units. The units that the tenant-stockholder has the right to occupy can be rented to others.

Deductible taxes. You figure your share of real estate taxes in the following way.

1. Divide the number of your shares of stock by the total number of shares outstanding, including any shares held by the corporation.
2. Multiply the corporation’s deductible real estate taxes by the number you figured in (1). This is your share of the real estate taxes.
3. Generally, the corporation will tell you your share of the real estate tax. This is the amount you can deduct if it reasonably reflects the cost of real estate taxes for your dwelling unit.

Refund of real estate taxes. If the corporation receives a refund of real estate taxes it paid in an earlier year, it must reduce the amount of real estate taxes paid this year when it allocates the tax expense to you. Your deduction for real estate taxes the corporation paid this year is reduced by your share of the refund the corporation received.

Sales Taxes

You can elect to deduct state and local general sales taxes instead of state and local income taxes as an itemized deduction on Schedule A (Form 1040). Deductible sales taxes may include sales taxes paid on the purchase of a home. For information on figuring your deduction, see the instructions for Schedule A (Form 1040) and Publication 600, Optional State Sales Tax Tables.

If you elect to deduct the sales taxes, you cannot include them as part of your cost basis in the home.

Home Mortgage Interest

This section of the publication gives you basic information about home mortgage interest, including information on interest paid at settlement, points, and Form 1098, Mortgage Interest Statement.

Most home buyers take out a mortgage (loan) to buy their home. They then make monthly payments to either the mortgage holder or someone collecting the payments for the mortgage holder. (See Your house payment, earlier, under What You Can and Cannot Deduct.) Usually, you can deduct the entire part of your payment that is for mortgage interest, if you itemize your deductions on Schedule A (Form 1040). However, your deduction may be limited if:

- Your total mortgage balance is more than $1 million ($500,000 if married filing separately), or
- You took out a mortgage for reasons other than to buy, build, or improve your home.

If either of these situations applies to you, you will need to get Publication 936. You also may need Publication 936 if you later refinance your mortgage or buy a second home.

Refund of home mortgage interest. If you receive a refund of home mortgage interest that you deducted in an earlier year and that reduced your tax, you generally must include the refund in income in the year you receive it. For more information, see Publication 525. The amount of the refund will usually be shown on the mortgage interest statement you receive from your mortgage lender. See Mortgage Interest Statement, later.

Deductible Mortgage Interest

To be deductible, the interest you pay must be on a loan secured by your main home or a second home. The loan can be a first or second mortgage, a home improvement loan, or a home equity loan.

Prepaid interest. If you pay interest in advance for a period that goes beyond the end of the tax year, you must spread this interest over the tax years to which it applies. You can deduct in each year only the interest that qualifies as home mortgage interest for that year. However,
there is an exception that applies to points, dis-
cussed later.

Late payment charge on mortgage payment. You can deduct as home mortgage interest a late payment charge if it was not for a specific service in connection with your mortgage loan.

Mortgage prepayment penalty. If you pay off your home mortgage early, you may have to pay a penalty. You can deduct that penalty as home mortgage interest provided the penalty is not for a specific service performed or cost incurred in connection with your mortgage loan.

Ground rent. In some states (such as Mary-
land), you may buy your home subject to a ground rent. A ground rent is an obligation you assume to pay a fixed amount each year on the property. Under this arrangement, you are leasing (rather than buying) the land on which your home is located.

Reredeemable ground rents. If you make annual or periodic rental payments on a re-
deedable ground rent, you can deduct the pay-
ments as mortgage interest. The ground rent is a reredeemable ground rent only if all of the follow-
ing are true:
- Your lease, including renewal periods, is for more than 5 years.
- You can freely assign the lease.
- You have a present or future right (under state or local law) to end the lease and buy the lessor’s entire interest in the land by paying a specified amount.
- The lessor’s interest in the land is primarily a security interest to protect the rental payments to which he or she is entitled.

Payments made to end the lease and buy the lessor’s entire interest in the land are not re-
deedable ground rents. You cannot deduct them.

Nonredeemable ground rents. Payments on a nonredeemable ground rent are not mort-
gage interest. If you can deduct them as rent only if they are a business expense or if they are for rental property.

Cooperative apartment. You can usually treat the interest on a loan you took out to buy stock in a cooperative housing corporation as home mortgage interest if you own a coop-

erative apartment and the cooperative housing corporation meets the conditions described earlier under Special Rules for Cooperatives. In addi-
tion, you can treat as home mortgage interest your share of the corporation’s deductible mort-
gage interest. Figure your share of mortgage interest the same way that is shown for figuring your share of real estate taxes in the Example under Division of real estate taxes. For more information on cooperatives, see Special Rule for Tenant-Stockholders in Cooperative Housing Corporations in Publication 936.

Refund of cooperative’s mortgage inter-
est. You must reduce your mortgage interest deduction by your share of any cash portion of a patronage dividend that the cooperative re-
ceives. The patronage dividend is a partial re-
fund to the cooperative housing corporation of mortgage interest it paid in a prior year. If you receive a Form 1098 from the coopera-
tive housing corporation, the form should show only the amount you can deduct.

Mortgage Interest Paid at Settlement
One item that normally appears on a settlement or closing statement is home mortgage interest. You can deduct the interest that you pay at settlement if you itemize your deductions on Schedule A (Form 1040). This amount should be included in the mortgage interest statement provided by your lender. See the discussion under Mortgage Interest Statement, later. Also, if you pay interest in advance, see Prepaid inter-
est, earlier, and Points, next.

Points
The term “points” is used to describe certain charges paid, or treated as paid, by a borrower to obtain a home mortgage. Points also may be called loan origination fees, maximum loan charges, loan discount, or discount points. A borrower is treated as paying any points that a home seller pays for the borrower’s mort-

age. See Points paid by the seller, later.

General rule. You cannot deduct the full amount of points in the year paid. They are pre-

paid interest, so you generally must deduct them over the life (term) of the mortgage.

Exception. You can deduct the full amount of points in the year paid if you meet all the following tests.
- Your loan is secured by your main home. (Generally, your main home is the one you live in most of the time.)
- You pay points on an established business practice in the area where the loan was made.
- The points paid were not more than the points generally charged in that area.
- You use the cash method of accounting. This means you report income in the year you receive it and deduct expenses in the year you pay them. Most individuals use this method.
- The points were not paid in place of amounts that ordinarily are stated sepa-

rately on the settlement statement, such as appraisal fees, inspection fees, title fees, attorney fees, and property taxes.
- The funds you provided at or before clos-

ing, plus any points the seller paid, were at least as much as the points charged. The funds you provided do not have to have been applied to the points. They can in-
clude a down payment, an escrow deposit, earnest money, and other funds you paid at or before closing for any purpose. You cannot have borrowed these funds from your lender or mortgage broker.
- You use your loan to buy or build your main home.
- The points were computed as a percent-

age of the principal amount of the mort-

gage.
- The amount is clearly shown on the settle-

ment statement (such as the Uniform Set-
tlement Statement, Form HUD-1) as points charged for the mortgage. The points may be shown as paid from either your funds or the seller’s.

Note. If you meet all of the tests listed above and you itemize your deductions in the year you get the loan, you can either deduct the full amount of points in the year paid or deduct them over the life of the loan, beginning in the year you get the loan. If you do not itemize your deductions in the year you get the loan, you can spread the points over the life of the loan and deduct the appropriate amount in each future year, if any, when you do itemize your deduc-
tions.

Home improvement loan. You can also fully deduct in the year paid points paid on a loan to improve your main home, if tests (1) through (6) are met.

Points not fully deductible in year paid. If you do not qualify under the exception to deduct the full amount of points in the year paid (or choose not to do so), see Points in chapter 5 of Publication 535, Business Expenses, for the rules on when and how much you can deduct.

Figure A. You can use Figure A as a quick guide to see whether your points are fully de-
ductible in the year paid.

Amounts charged for services. Amounts charged by the lender for specific services con-

nected to the loan are not deductible. Examples of these charges are:
- Appraisal fees,
- Notary fees,
- Preparation costs for the mortgage note or deed of trust,
- Mortgage insurance premiums, and
- VA funding fees.

You cannot deduct these amounts as points either in the year paid or over the life of the mort-
gage. For information about the tax treat-
ment of these amounts and other settlement fees and closing costs, see Basis, later.

Points paid by the seller. The term points includes loan placement fees that the seller pays to the lender to arrange financing for the buyer.

Treatment by seller. The seller cannot de-
duct these fees as interest; but, they are a sell-
ing expense that reduces the seller’s amount realized. See Publication 523 for more informa-
tion.

Treatment by buyer. The buyer treats seller-paid points as if he or she had paid them. If all the tests under Exception (discussed ear-
lier) are met, the buyer can deduct the points in the year paid. If any of those tests are not met, the buyer must deduct the points over the life of the loan.

The buyer must also reduce the basis of the home by the amount of the seller-paid points. For more information about the basis of your home, see Basis, later.

Funds provided are less than points. If you meet all the tests under Exception (discussed earlier) except that the funds you provided were less than the points charged to you (test 6), you can deduct the points in the year paid up to the amount of funds you provided. In addition, you can deduct any points paid by the seller.

Example 1. When you took out a $100,000 mortgage loan to buy your home in December, you were charged one point ($1,000). You meet...
Figure A. Are My Points Fully Deductible This Year?

Start Here:

Is the loan secured by your main home?  
Yes

Is the payment of points an established business practice in your area?  
Yes

Were the points paid more than the amount generally charged in your area?  
No

Do you use the cash method of accounting?  
Yes

Were the points paid in place of amounts that ordinarily are separately stated on the settlement sheet?  
No

Were the funds you provided (other than those you borrowed from your lender or mortgage broker), plus any points the seller paid, at least as much as the points charged?*  
Yes

Did you take out the loan to improve your main home?  
No

Did you take out the loan to buy or build your main home?  
Yes

Were the points computed as a percentage of the principal amount of the mortgage?  
No

Is the amount paid clearly shown as points on the settlement statement?  
Yes

You can fully deduct the points this year.  

You cannot fully deduct the points this year. See the discussion on Points.

* The funds you provided do not have to have been applied to the points. They can include a down payment, an escrow deposit, earnest money, and other funds you paid at or before closing for any purpose.
all the tests for deducting points in the year paid (see Example 1), except that the points paid to your home also paid one point ($1,000) to help you get your mortgage. In the year paid, you can deduct $1,750 ($750 of the amount you were charged plus the $1,000 paid by the seller). You spread the remaining $250 over the life of the mortgage.

Example 2. The facts are the same as in Example 1, except that the person who sold you your home also paid one point ($1,000) to help you get your mortgage. If you received points in 1997, you can deduct any remaining balance in the year the mortgage ends. A mortgage may end early due to a prepayment, refinancing, foreclosure, or similar event.

Excess points. If you meet all the tests under Exception except that the points paid were more than are generally charged in your area (test 3), you can deduct in the year paid only the points that are generally charged. You must spread any additional points over the life of the mortgage.

Mortgage ending early. If you spread your deduction for points over the life of the mortgage, you can deduct any remaining balance in the year the mortgage ends. A mortgage may end early due to a prepayment, refinancing, foreclosure, or similar event.

Example. Dan paid $3,000 in points in 1997 that he had to spread out over the 15-year life of the mortgage. He had deducted $1,400 of these points through 2003. Dan prepaid his mortgage in full in 2004. He can deduct the remaining $1,600 of points in 2004.

Exception. If you refinance the mortgage with the same lender, you cannot deduct any remaining points for the year. Instead, deduct them over the term of the new loan.

Form 1098. The mortgage interest statement you receive should show not only the total interest paid during the year, but also your deductible points paid during the year. See Mortgage Interest Statement, later.

Where To Deduct Home Mortgage Interest

Enter on Schedule A (Form 1040), line 10, the home mortgage interest and points reported to you on Form 1098 (discussed next). If you did not receive a Form 1098, enter your deductible interest on line 11, and any deductible points on line 12. See Table 1 for a summary of where to deduct home mortgage interest and real estate taxes.

Refund of overpaid interest. If you receive a refund of mortgage interest you overpaid in a prior year, you generally will receive a Form 1098 showing the refund in box 3. Generally, you must include the refund in income in the year you receive it. See Refund of home mortgage interest, earlier, under Home Mortgage Interest.

More than one borrower. If you and at least one other person (other than your spouse if you file a joint return) were liable for and paid interest on a mortgage that was for your home, and the other person received a Form 1098 showing the interest that was paid during the year, attach a statement to your return explaining this. Show how much of the interest each of you paid, and give the name and address of the person who received the form. Deduct your share of the interest on Schedule A (Form 1040), line 11, and write “See attached” to the right of that line.

Mortgage Interest Credit

The mortgage interest credit is intended to help lower-income individuals afford home ownership. If you qualify, you can claim the credit each year for part of the home mortgage interest you pay.

Who qualifies. You may be eligible for the credit if you were issued a mortgage credit certificate (MCC) from your state or local government. Generally, an MCC is issued only in connection with a new mortgage for the purchase of your main home.

The MCC will show the certificate credit rate you will use to figure your credit. It also will show the certified indebtedness amount. Only the interest on that amount qualifies for the credit. See Figuring the Credit, later.

TIP
You must contact the appropriate government agency about getting an MCC before you get a mortgage and buy your home. Contact your state or local housing finance agency for information about the availability of MCCs in your area.

How to claim the credit. To claim the credit, complete Form 8936 and attach it to your Form 1040. Include the credit in your total for Form 1040, line 53; be sure to check box a on that line. Reduce your home mortgage interest deduction. If you itemize your deductions on Schedule A (Form 1040), you must reduce your home mortgage interest deduction by the amount of the mortgage interest credit shown on Form 8396, line 3. You must do this even if part of that amount is to be carried forward to 2005.

Selling your home. If you purchase a home after 1990 using an MCC, and you sell that home within 9 years, you may have to recapture (repay) all or part of the benefit you received from the MCC program. For additional information, see Recapring (Paying Back) a Federal Mortgage Subsidy, in Publication 523.

Figuring the Credit

Figure your credit on Form 8396.

Mortgage not more than certified indebtedness. If your mortgage loan amount is equal to (or smaller than) the certified indebtedness

IF you are eligible to deduct . . .

Real estate taxes

Home mortgage interest and points reported on Form 1098

Home mortgage interest not reported on Form 1098

Points not reported on Form 1098

THEN report the amount on Schedule A (Form 1040) . . .

line 6

line 10

line 11

line 12

Table 1. Where To Deduct Interest and Taxes Paid on Your Home

See the text for information on what expenses are eligible.
amount shown on your MCC, enter on Form 8396, line 1, all the interest you paid on your mortgage during the year.

Mortgage more than certified indebtedness. If your mortgage loan amount is larger than the certified indebtedness amount shown on your MCC, you can figure the credit on only part of the interest you paid. To find the amount to enter on line 1, multiply the total interest you paid during the year on your mortgage by the following fraction.

\[
\text{Certified indebtedness amount} \times \frac{\text{amount on your mortgage}}{100}
\]

Example. Emily bought a home this year. Her mortgage loan is $125,000. The certified indebtedness amount on her MCC is $100,000. She paid $7,500 interest this year. Emily figures the interest to enter on Form 8396, line 1, as follows:

\[
\frac{\$100,000}{\$125,000} = 80\% \quad (\text{.80})
\]

$7,500 x .80 = $6,000

Emily enters $6,000 on Form 8396, line 1. In each later year, she will figure her credit using only 80% of the interest she pays for that year.

Limits

Two limits may apply to your credit.

- A limit based on the credit rate, and
- A limit based on your tax.

Limit based on credit rate. If the certificate credit rate is higher than 20%, the credit you are allowed cannot be more than $2,000.

Limit based on tax. Your credit (after applying the limit based on the credit rate) generally cannot be more than your regular tax liability on Form 1040, line 43, plus any alternative minimum tax on Form 1040, line 44, minus certain other credits. Use Form 8396 to figure this limit.

Dividing the Credit

If two or more persons (other than a married couple filing a joint return) hold an interest in the home to which the MCC relates, the credit must be divided based on the interest held by each person.

Example. John and his brother, George, were issued an MCC. They used it to get a mortgage on their main home. John has a 60% ownership interest in the home, and George has a 40% ownership interest in the home. John paid $5,400 mortgage interest this year and George paid $3,600.

The MCC shows a credit rate of 25% and a certified indebtedness amount of $130,000. The loan amount (mortgage) on their home is $120,000. The credit is limited to $2,000 because the credit rate is more than 20%.

John figures the credit by multiplying the mortgage interest he paid this year ($5,400) by the certificate credit rate (25%) for a total of $1,350. His credit is limited to $1,200 ($2,000 x 60%).

George figures the credit by multiplying the mortgage interest he paid in this year ($3,600) by the certificate credit rate (25%) for a total of $900. His credit is limited to $800 ($2,000 x 40%).

Carryforward

If your allowable credit is reduced because of the limit based on your tax, you can carry forward the unused portion of the credit to the next 3 years or until used, whichever comes first.

Example. You receive a mortgage credit certificate from State X. This year, your regular tax liability is $1,100, you owe no alternative minimum tax, and your mortgage interest credit is $1,700. You claim no other credits. Your unused mortgage interest credit for this year is $600 ($1,700 – $1,100). You can carry forward this amount to the next 3 years or until used, whichever comes first.

Credit rate more than 20%. If you are subject to the $2,000 limit because your certificate credit rate is more than 20%, you cannot carry forward any amount more than $2,000 (or your share of the $2,000 if you must divide the credit).

Example. In the earlier example under Dividing the Credit, John and George used the entire $2,000 credit. The excess $150 for John ($1,350 − $1,200) and $100 for George ($900 − $800) cannot be carried forward to future years, despite the respective tax liabilities for John and George.

Refinancing

If you refinance your original mortgage loan on which you had been given an MCC, you must get a new MCC to be able to claim the credit on the new loan. The amount of credit you can claim on the new loan may change. Table 2 summarizes how to figure your credit if you refinance your original mortgage loan.

An issuer may reissue an MCC after you refinance your mortgage, but only up to one year after the date of the refinancing. If you did not get a new MCC, you may want to contact the state or local housing finance agency that issued your original MCC for information about whether you can get a reissued MCC.

Year of refinancing. In the year of refinancing, add the applicable amount of interest paid on the old mortgage and the applicable amount of interest paid on the new mortgage, and enter the total on Form 8396, line 1.

If your new MCC has a credit rate different from the rate on the old MCC, you must attach a statement to Form 8396. The statement must show the calculation for lines 1, 2, and 3 for the part of the year when the old MCC was in effect. It must show a separate calculation for the part of the year when the new MCC was in effect. Combine the amounts from both calculations for line 3, enter the total on line 3 of the form, and write “see attached” on the dotted line.

New MCC cannot increase your credit. The credit that you claim with your new MCC cannot be more than the credit that you could have claimed with your old MCC.

In most cases, the agency that issues your new MCC will make sure that it does not increase your credit. However, if either your old loan or your new loan has a variable (adjustable) interest rate, you will need to check this yourself.

In that case, you will need to know the amount of the credit you could have claimed using the old MCC.

There are two methods for figuring the credit you could have claimed. Under one method, you figure the actual credit that would have been allowed. This means you use the credit rate on the old MCC and the interest you would have paid on the old loan.

If your old loan was a variable rate mortgage, you can use another method to determine the credit that you could have claimed. Under this method, you figure the credit using a payment schedule of a hypothetical self-amortizing mortgage with level payments projected to the final maturity date of the old mortgage. The interest rate of the hypothetical mortgage is the annual percentage rate (APR) of the new mortgage for purposes of the Federal Truth in Lending Act. The principal of the hypothetical mortgage is the remaining outstanding balance of the certified mortgage indebtedness shown on the old MCC.

You must choose one method and use it consistently beginning with the first tax year for which you claim the credit based on the new MCC.

As part of your tax records, you should keep your old MCC and the schedule of payments for your old mortgage.
### Basis

Basis is your starting point for figuring a gain or loss if you later sell your home, or for figuring depreciation if you later use part of your home for business purposes or for rent.

While you own your home, you may add certain items to your basis. You may subtract certain other items from your basis. These items are called adjustments to basis and are explained later under Adjusted Basis.

It is important that you understand these terms when you first acquire your home because you must keep track of your basis and adjusted basis during the period you own your home. You also must keep records of the events that affect basis or adjusted basis. See Keeping Records, later.

### Figuring Your Basis

How you figure your basis depends on how you acquire your home. If you buy or build your home, your cost is your basis. If you receive your home as a gift, your basis is usually the same as the adjusted basis of the person who gave you the property. If you inherit your home from a decedent, the fair market value at the date of the decedent’s death is generally your basis. Each of these topics is discussed later.

**Fair market value.** This is the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and who both have a reasonable knowledge of all the necessary facts.

**Property transferred from a spouse.** If your home is transferred to you from your spouse, or from your former spouse as a result of a divorce, your basis is the same as your spouse’s (or former spouse’s) adjusted basis just before the transfer. Publication 504, Divorced or Separated Individuals, fully discusses transfers between spouses.

### Cost as Basis

The cost of your home, whether you purchased it or constructed it, is the amount you paid for it, including any debt you assumed.

#### Increases to Basis

- Putting an addition on your home
- Replacing an entire roof
- Paving your driveway
- Installing central air conditioning
- Rewiring your home
- Assessments for local improvements (see Assessments for local benefits, under What You Can and Cannot Deduct)
- Amounts spent to restore damaged property

#### Decreases to Basis

- Insurance or other reimbursement for casualty losses
- Deductible casualty loss not covered by insurance
- Payments received for easement or right-of-way granted
- Dedication allowed or allowable if home is used for business or rental purposes
- Value of subsidy for energy conservation measure excluded from income

The cost of your home includes most settlement or closing costs you paid when you bought the home. If you built your home, your cost includes most closing costs paid when you bought the land or settled on your mortgage.

If you elect to deduct the sales taxes on the purchase or construction of your home as an itemized deduction on Schedule A (Form 1040), you cannot include the amount you paid for your shares in the corporation that owns or controls the property. This amount includes any purchases commissions or other costs of acquiring the shares.

**Construction.** If you contracted to have your home built on land that you own, your basis in the home is the basis in the land plus the amount you paid to have the home built. This includes the cost of labor and materials, the amount you paid the contractor, any architect’s fees, building permit charges, utility meter and connection charges, and legal fees that are directly connected with building your home. If you built all or part of your home yourself, your basis is the total amount it cost you to build it. You cannot include the value of your own labor or any other labor for which you did not pay.

**Real estate taxes.** Real estate taxes are usually divided so that you and the seller each pay taxes for the part of the property tax year that each owned the home. See the earlier discussion of Real estate taxes paid at settlement or closing, under Real Estate Taxes, to figure the real estate taxes you paid or are considered to have paid.

If you pay any part of the seller’s share of the real estate taxes (the taxes up to the date of sale), and the seller did not reimburse you, add those taxes to your basis in the home. You cannot deduct them as taxes paid.

If the seller paid any of your share of the real estate taxes (the taxes beginning with the date of sale), you can still deduct those taxes. Do not include those taxes in your basis. If you did not reimburse the seller, you must reduce your basis by the amount of those taxes.

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**Example 1.** You bought your home on September 1. The property tax year in your area is the calendar year, and the tax is due on August 15. The real estate taxes on the home you bought were $1,275 for the year and had been paid by the seller on August 15. You did not reimburse the seller for your share of the real estate taxes from September 1 through December 31. You must reduce the basis of your home by $425 ([122 ÷ 366] × $1,275) the seller paid for you. You can deduct your $425 share of real estate taxes on your return for the year you purchased your home.

**Example 2.** You bought your home on May 3, 2004. The property tax year in your area is the calendar year. The taxes for the previous year are assessed on January 2 and are due on May 31 and November 30. Under state law, the taxes become a lien on May 31. You agreed to pay all taxes due after the date of sale. The taxes due in 2004 for 2003 were $1,375. The taxes due in 2005 for 2004 will be $1,425.

You cannot deduct any of the taxes paid in 2004 because they relate to the 2003 property tax year and you did not own the home until 2004. Instead, you add the $1,375 to the cost (basis) of your home.

You owned the home in 2004 for 243 days. (May 3 to December 31), so you can take a tax deduction on your 2005 return of $946 ([243 ÷ 366] × $1,425) paid in 2005 for 2004. You add the remaining $479 ($1,425 - $946) of taxes paid in 2005 to the cost (basis) of your home.

**Settlement or closing costs.** If you bought your home, you probably paid settlement or closing costs in addition to the contract price. These costs are divided between you and the seller according to the sales contract, local custom, or understanding of the parties. If you built your home, you probably paid these costs when you bought the land or settled on your mortgage.

The only settlement or closing costs you can deduct are home mortgage interest and certain real estate taxes. You may deduct the real estate taxes due after the date of sale. The taxes due on your home from September 1 through December 31 of the year you bought your home if you itemize your deductions.

You can add certain other settlement or closing costs to the basis of your home.

**Items added to basis.** You can include in your basis the settlement fees and closing costs you paid for buying your home. A fee is for buying the home if you would have had to pay it even if you paid cash.

The following are some of the settlement fees and closing costs that you can include in the original basis of your home.

- Abstract fees (abstract of title fees).
- Charges for installing utility services.
- Legal fees (including fees for the title search and preparation of the sales contract and deed).
- Recording fees.
- Surveys.
- Transfer taxes.
- Owner’s title insurance.
- Any amount the seller owes that you agree to pay, such as back taxes or interest, cost of improvements or repairs, and sales commissions.
If the seller actually paid for any item for which you are liable and for which you can take a deduction (such as your share of the real estate taxes for the year of sale), you must reduce your basis by that amount unless you are charged for it in the settlement.

**Items not added to basis and not deductible.** Here are some settlement and closing costs that you cannot deduct or add to your basis.

1. Fire insurance premiums.
2. Charges for using utilities or other services related to occupancy of the home before closing.
3. Rent for occupying the home before closing.
4. Charges connected with getting or refinancing a mortgage (such as FHA or other mortgage insurance premiums and VA funding fees).

**Gift.**

To figure the basis of property you receive as a gift, you must know its adjusted basis (defined later) to the donor just before it was given to you, adds to the value of your home, considerably is up to you, but they must be clear and accurate due to the net increase in value of the home.

If someone gave you your home property and, after you dispose of it, for thekeeps your home in an ordinary, efficient condition. It does not add to the value of it was given to you, was equal to or less than the Donor’s adjusted basis equal to or less than

Generally, this means for as long as you own the Improvements.

**Gift.**

If you bought your home after April 3, 1994, you must reduce your basis by any points paid for your mortgage by the person who sold you your home. If you bought your home after 1990 but before April 4, 1994, you must reduce your basis by seller-paid points only if you deducted them. See Points, earlier, for the rules on deducting points.

**Points paid by seller.** If you bought your home after April 3, 1994, you must reduce your basis by any points paid for your mortgage by the person who sold you your home. If you bought your home after 1990 but before April 4, 1994, you must reduce your basis by seller-paid points only if you deducted them. See Points, earlier, for the rules on deducting points.

**Gift.**

If the donor’s adjusted basis is more than FMV. If someone gave you your home and the donor’s adjusted basis, when it was given to you, was more than the fair market value, your basis at the time of receipt is the same as the donor’s adjusted basis.

**Disposition basis.** If the donor’s adjusted basis at the time of the gift is more than the FMV, your basis when you dispose of the property will depend on whether you have a gain or a loss.

- If using the donor’s adjusted basis results in a loss when you sell the home, you must use the fair market value of the home at the time of the gift as your basis.
- If using the fair market value results in a gain, you have neither a gain nor a loss.

**Donor’s adjusted basis equal to or less than the FMV.** If someone gave you your home after 1976 and the donor’s adjusted basis, when it was given to you, was equal to or less than the fair market value, your basis at the time of receipt is the same as the donor’s adjusted basis, plus the part of any federal gift tax paid that is due to the net increase in value of the home.

**Part of federal gift tax due to net increase in value.** Figure the part of the federal gift tax paid that is due to the net increase in value of the home by multiplying the total federal gift tax paid by a fraction. The numerator (top part) of the fraction is the net increase in the value of the home, and the denominator (bottom part) is the value of the home for gift tax purposes after deduction for any annual exclusion and marital or charitable deduction that applies to the gift. The net increase in the value of the home is its fair market value minus the adjusted basis of the donor.

**Publication 551 gives more information, including examples, on figuring your basis when you receive property as a gift.**

**Inheritance.**

Your basis in a home you inherited is generally the fair market value of the home on the date of the decedent’s death or on the alternate valuation date if the personal representative for the estate chooses to use alternative valuation. If an estate tax return was filed, your basis is generally the value of the home listed on the estate tax return.

If an estate tax return was not filed, your basis is the appraised value of the home at the decedent’s date of death for state inheritance or transmission taxes. Publication 551 and Publication 559, Survivors, Executors, and Administrators, have more information on the basis of inherited property.

**Adjusted Basis.**

While you own your home, various events may take place that can change the original basis of your home. These events can increase or decrease your original basis. The result is called your adjusted basis. See Table 3, earlier, for a list of some of the items that can add to your basis.

**Improvements.** An improvement materially adds to the value of your home, considerably prolongs its useful life, or adapts it to new uses. You must add the cost of any improvements to the basis of your home. You cannot deduct these costs.

Improvements include putting a recreation room in your unfinished basement, adding another bathroom or bedroom, putting up a fence, putting in new plumbing or wiring, installing a new roof, and paving your driveway.

**Amount added to basis.** The amount you add to your basis for improvements is your actual cost. This includes all costs for material and labor, except your own labor, and all expenses related to the improvement. For example, if you had your lot surveyed to put up a fence, the cost of the survey is a part of the cost of the fence. You also must add to your basis state and local assessments for improvements such as streets and sidewalks if they increase the value of the property. These assessments are discussed earlier under Real Estate Taxes.

**Repairs versus improvements.** A repair keeps your home in an ordinary, efficient operating condition. It does not add to the value of your home or prolong its life. Repairs include repainting your home inside or outside, fixing your gut-
The type and rule above prints on all proofs including departmental reproduction proofs. MUST be removed before printing.

# Table 4. Record of Home Improvements

Keep this for your records. Also, keep receipts or other proof of improvements.

<table>
<thead>
<tr>
<th>Type of Improvement</th>
<th>Date</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Additions:</strong></td>
<td></td>
<td></td>
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<tr>
<td>Bedroom</td>
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<td>Bathroom</td>
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<tr>
<td>Deck</td>
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<td>Garage</td>
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<td>Porch</td>
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<tr>
<td>Patio</td>
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<td>Storage shed</td>
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<tr>
<td>Fireplace</td>
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<tr>
<td>Other</td>
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<tr>
<td><strong>Lawn &amp; Grounds:</strong></td>
<td></td>
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<tr>
<td>Landscaping</td>
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<td>Driveway</td>
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<td>Walkway</td>
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<tr>
<td>Fences</td>
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<tr>
<td>Retaining wall</td>
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<td>Sprinkler system</td>
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<td>Swimming pool</td>
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<td>Exterior lighting</td>
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<tr>
<td>Other</td>
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<tr>
<td><strong>Communications:</strong></td>
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<tr>
<td>Satellite dish</td>
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<td>Intercom</td>
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<td>Security system</td>
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<td>Other</td>
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<tr>
<td><strong>Miscellaneous:</strong></td>
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<tr>
<td>Storm windows and doors</td>
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<tr>
<td>Roof</td>
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<tr>
<td>Central vacuum</td>
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<td>Other</td>
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<tr>
<td><strong>Electrical:</strong></td>
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<tr>
<td>Lighting fixtures</td>
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<td>Wiring upgrades</td>
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<tr>
<td>Other</td>
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<tr>
<td><strong>Plumbing:</strong></td>
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<tr>
<td>Water heater</td>
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<tr>
<td>Soft water system</td>
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<td>Filtration system</td>
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<td>Other</td>
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<tr>
<td><strong>Insulation:</strong></td>
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<td>Attic</td>
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<tr>
<td>Walls</td>
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<td>Floors</td>
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<tr>
<td>Pipes and duct work</td>
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<tr>
<td>Other</td>
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<tr>
<td><strong>Interior Improvements:</strong></td>
<td></td>
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<tr>
<td>Built-in appliances</td>
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<tr>
<td>Kitchen modernization</td>
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<td>Bathroom modernization</td>
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<tr>
<td>Flooring</td>
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<tr>
<td>Wall-to-wall carpeting</td>
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<tr>
<td>Other</td>
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</tbody>
</table>
How To Get Tax Help

You can get help with unresolved tax issues, order free publications and forms, ask tax questions, and get more information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

Contacting your Taxpayer Advocate. If you have attempted to resolve a tax problem unsuccessfully, you should contact your Taxpayer Advocate.

The Taxpayer Advocate independently represents your interests and concerns within the IRS by protecting your rights and resolving problems that have not been fixed through normal channels. While Taxpayer Advocates cannot change the tax law or make a technical tax decision, they can clear up problems that resulted from previous contacts and ensure that your case is given a complete and impartial view.

To contact your Taxpayer Advocate:
- Call the Taxpayer Advocate toll free at 1-877-777-4778.
- Call, write, or fax the Taxpayer Advocate office in your area.
- Call 1-800-829-4059 if you are a TTY/TDD user.

For more information, see Publication 1546, The Taxpayer Advocate Service of the IRS—How To Get Help With Unresolved Tax Problems.

Free tax services. To find out what services are available, get Publication 910, IRS Guide To Free Tax Services. It contains a list of free tax publications and an index of tax topics. It also describes other free tax information services, including tax education and assistance programs and a list of TeleTax topics.

Internet. You can access the IRS website 24 hours a day, 7 days a week, at www.irs.gov.

- E-file your return. Find out about commercial tax preparation and e-file services available free to eligible taxpayers.
- Check the status of your 2004 refund. Click on Where's My Refund? Be sure to wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically). Have your 2004 tax return available because you will need to know your filing status and the exact whole dollar amount of your refund.
- Download forms, instructions, and publications.
- Order IRS products online.
- Research your tax questions online.
- Search publications online by topic or keyword.
- View Internal Revenue Bulletins (IRBs) published in the last few years.
- Figure your withholding allowances using our Form W-4 calculator.
- Sign up to receive local and national tax news by email.
- Get information on starting and operating a small business.
- Fax. You can get over 100 of the most requested forms and instructions 24 hours a day, 7 days a week, by fax. Just call 703-368-9694 from the telephone connected to your fax machine. When you call, you will hear instructions on how to use the service. If you have questions, call 703-487-4608.
- Long-distance charges may apply.
- Phone. Many services are available by phone.
- Ordering forms, instructions, and publications. Call 1-800-829-3678 to order current-year forms, instructions, and publications.
- Asking tax questions. Call the IRS with your tax questions at 1-800-829-1040.
- Solving problems. You can get face-to-face help solving tax problems every business day in IRS Taxpayer Assistance Centers. An employee can explain IRS letters, request adjustments to your account, or help you set up a payment plan. Call your local Taxpayer Assistance Center for an appointment. To find your nearest office, go to www.irs.gov/localcontacts or look in the phone book under United States Government, Internal Revenue Service.
- TTY/TDD equipment. Have your access to TTY/TDD equipment, call 1-800-829-4059 to ask tax questions or to order forms and publications.
- TaxTel topics. Call 1-800-829-4477 and press 2 to listen to pre-recorded messages covering various tax topics.
- Refund information. If you would like to check the status of your 2004 refund, call 1-800-829-4477 and press 1 for automated refund information or call 1-800-829-1954. Be sure to wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically). Have your 2004 tax return available because you will need to know your filing status and the exact whole dollar amount of your refund.

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we use several methods to evaluate the quality of our telephone services. One method is for a second IRS representative to sometimes listen in on or record telephone calls. Another is to ask callers to complete a short survey at the end of the call.

Walk-in. Many products and services are available on a walk-in basis.

- Products. You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Some IRS offices, libraries, grocery stores, copy centers, city and county government offices, credit unions, and office supply stores have a collection of products available to print from a CD-ROM or photocopied from reproducible products. Also, some IRS offices and libraries have the Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletin Indexes available for research purposes.
- Services. You can walk in to your local Taxpayer Assistance Center every business day to ask tax questions or get help with a tax problem. An employee can explain IRS letters, request adjustments to your account, or help you set up a payment plan. You can set up an appointment by calling your local center at, and at the prompt, leaving a message requesting Everyday Tax Solutions help. A representative will call you back within 2 business days to schedule an in-person appointment at your convenience. To find the number, go to www.irs.gov/localcontacts or look in the phone book under United States Government, Internal Revenue Service.

Mail. You can send your order for forms, instructions, and publications to the Distribution Center nearest to you and receive a response within 10 business days after your request is received. Use the address that applies to your part of the country.

- Western part of U.S.: Western Area Distribution Center, Rancho Cordova, CA 95743-0001
- Central part of U.S.: Central Area Distribution Center, P.O. Box 8903, Bloomington, IL 61702-8903
- Eastern part of U.S. and foreign addresses: Eastern Area Distribution Center, P.O. Box 85074, Richmond, VA 23261-5074

CD-ROM for tax products. You can order Publication 1796, IRS Federal Tax Products CD-ROM, and obtain:

- Current-year forms, instructions, and publications.
- Prior-year forms and instructions.
- Frequently requested tax forms that may be filed in electronically, printed out for submission, or saved for recordkeeping.
- Internal Revenue Bulletins.

Buy the CD-ROM from National Technical Information Service (NTIS) at www.irs.gov/ntis. Certification for $22 ($25 handling fee) or call 1-877-233-6767 toll free to buy the CD-ROM for $22 (plus a $5 handling fee). The first release is
available in early January and the final release is available in late February.

**CD-ROM for small businesses.** Publication 3207, The Small Business Resource Guide, CD-ROM 2004, is a must for every small business owner or any taxpayer about to start a business. This handy, interactive CD contains all the business tax forms, instructions, and publications needed to successfully manage a business. In addition, the CD provides other helpful information, such as how to prepare a business plan, finding financing for your business, and much more. The design of the CD makes finding information easy and quick and incorporates file formats and browsers that can be run on virtually any desktop or laptop computer. It is available in early April. You can get a free copy by calling 1-800-829-3676 or by visiting www.irs.gov/smallbiz.

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To help us develop a more useful index, please let us know if you have ideas for index entries.

See “Comments and Suggestions” in the “Introduction” for the ways you can reach us.

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