Tax Tips: Homeowners Insurance
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The purpose of home insurance is obvious. The tax rules surrounding home insurance, though, aren't always so clear. For example, if your insurance won't cover you for a given loss, are you simply left holding the bag, or can you expect some tax relief? And what about premiums--can you deduct them or not? Here are some tax tips to help you make sense of it all.

If your home or possessions are damaged, destroyed, or stolen, you may get a tax deduction

If you suffer a home-related loss, begin by reading your homeowners policy carefully to find out what is and isn't covered. Section 1 of your policy explains the types of property coverages, lists the specific perils that you're insured against (e.g., damage caused by fire, theft, and hail), describes the exclusions from coverage (e.g., damage caused by a flood or earthquake), and details any conditions that you must meet for coverage to apply.

In many cases, your homeowners insurance will reimburse you for your loss. Sometimes, though, you'll be only partially reimbursed or not compensated at all. In such cases, you may be entitled to some tax relief.

If your home is damaged or destroyed in an accident or by an act of nature (e.g., windstorm, lightning), and your homeowners insurance does not completely reimburse you for the loss, you may be able to claim a casualty loss tax deduction on your federal income tax return. (A casualty is the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual.) In addition, if your personal possessions are stolen, damaged, or destroyed, you may be able to claim a theft or casualty loss tax deduction if you're not fully reimbursed for your loss.

How does the theft or casualty loss deduction work?

You must file federal Form 1040 and itemize your deductions on Schedule A to claim a casualty or theft loss deduction. For individual taxpayers, the casualty or theft deduction is subject to two limitations. First, you can't deduct the first $100 of any loss. So, if your $99 watch was stolen from your bedroom and nothing else was taken, you're out of luck (at least in terms of a deduction). Second, even if your loss exceeds $100, you can only deduct casualty and theft losses if the total amount you lost in the year (after the $100 per casualty threshold) exceeds 10 percent of your adjusted gross income (AGI). However, casualty and theft losses are not subject to the overall limitation on itemized deductions based on your adjusted gross income.

If you're reimbursed for your loss by your insurer, you must subtract this reimbursement amount when calculating your loss for tax purposes. In other words, you do not have a casualty or theft loss to the extent you are reimbursed. Also, keep in mind that if you do suffer a property loss and the property is covered by insurance, you should file a timely insurance claim. Otherwise, you may not be able to deduct your loss.

Calculating the amount of your loss

If you suffer a personal (as opposed to business) property loss, the amount of your loss is the smaller of (1) the decrease in the fair market value (FMV) of the property as a result of the loss or (2) your adjusted basis in the property before the loss. (Adjusted basis is usually your cost, increased or decreased by various events.) After determining the smaller figure, you subtract any insurance reimbursements.

For example, assume a fire severely damaged your home. You had bought the house for $50,000 (adjusted basis) a few years ago, and it was appraised at $75,000 before the fire. It was worth only $15,000 after the fire. Your insurance company paid you $45,000 for the loss. Here's what you do:

1. Adjusted basis in the property before the loss: $50,000
2. Decrease in property's FMV: $60,000 ($75,000 minus $15,000)
3. Loss: $50,000 (smaller of 1 or 2, above)
4. Subtract insurance reimbursement of $45,000
5. Amount of loss: $5,000

Finally, you'd apply the two deduction limitations ($100 deductible; 10 percent of AGI) to determine the amount of your casualty loss.
loss deduction.

In general, you'll use Form 4684 to figure the amount of your deduction; consult a tax professional if you need help. IRS Publication 584 can also provide you with additional information.

What about insurance deductibles?

With most homeowners insurance policies, you must pay a deductible before the insurer will reimburse you (partially or fully) for your loss. So, if you have a policy with a $500 deductible and you suffer a theft loss, you'll have to cover the first $500 of your loss out of pocket. It's possible, though, that you'll be able to write off this deductible as a theft loss on your federal tax return (subject to the $100 and 10 percent rules).

Can you normally deduct your homeowners insurance premiums on your tax return?

If you're like most people and use your home only for personal purposes, you can't deduct your homeowners insurance premiums on your tax return.

Deducting your homeowners insurance premiums when you have a home office

If you have a home office and qualify to take a home office deduction, you may be able to deduct some of your housing expenses, including part of your homeowners insurance premiums, on your federal income tax return. A special formula is used to determine which portion of your housing expenses may be traced or allocated to your home office, and you'll be able to deduct the same percentage of your homeowners insurance premiums. For example, if you can allocate 15 percent of your housing expenses to your home office, you'll be able to deduct 15 percent of your premiums. However, you cannot deduct homeowners insurance premiums, or other actual business housing expenses, if you use the simplified safe harbor home office deduction method.

If you have a home-based business, though, you should consider purchasing additional insurance. A standard homeowners policy typically won't provide coverage for your business equipment in the home, and it won't cover business-related personal liability losses at all (including the delivery person who slips and falls). You may be able to add an endorsement to your existing homeowners policy, buy a home-based business package policy, or buy individual business insurance. Those insurance premiums would then be fully deductible against business income.
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