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|  | "Tax Tips" – Rent Vs. Buy |
| August 1st – September 30th, 2010 | By Milan Madhani, CPA Volume 1, Issue 4 |
| In This Issue   * [**Quick Terms**](#QuickTerms) * [**Quick Answer (15:1) Ratio**](#QuickAnswer) * [**Buying Benefits**](#BuyingBenefits) * [**Buying Costs**](#BuyingCosts) * [**Renting Benefits**](#RentingBenefits) * [**Renting Costs**](#RentingCosts) * [**Food for Thought – Loss of flexibility**](#FoodforThought)   Contact Us  939 N Plum Grove Rd  Suite A  Schaumburg, IL 60173  Ph.847.619.0413  Fx.847.619.0966  [http://www.vimlantax.com](http://www.adatum.com)  [info@vimlantax.com](mailto:someone@example.com)   * [**Quick Terms**](#QuickTerms) * [**Quick Answer (15:1) Ratio**](#QuickAnswer) * [**Buying Benefits**](#BuyingBenefits) * [**Buying Costs**](#BuyingCosts) * [**Renting Benefits**](#RentingBenefits) * [**Renting Costs**](#RentingCosts) * [**Food for Thought – Loss of flexibility**](#FoodforThought) * [**Quick Terms**](#QuickTerms) * [**Quick Answer (15:1) Ratio**](#QuickAnswer) * [**Buying Benefits**](#BuyingBenefits) * [**Buying Costs**](#BuyingCosts) * [**Renting Benefits**](#RentingBenefits) * [**Renting Costs**](#RentingCosts) * [**Food for Thought – Loss of flexibility**](#FoodforThought) * [**Quick Terms**](#QuickTerms) * [**Quick Answer (15:1) Ratio**](#QuickAnswer) * [**Buying Benefits**](#BuyingBenefits) * [**Buying Costs**](#BuyingCosts) * [**Renting Benefits**](#RentingBenefits) * [**Renting Costs**](#RentingCosts) * [**Food for Thought – Loss of flexibility**](#FoodforThought) * [**Quick Terms**](#QuickTerms) * [**Quick Answer (15:1) Ratio**](#QuickAnswer) * [**Buying Benefits**](#BuyingBenefits) * [**Buying Costs**](#BuyingCosts) * [**Renting Benefits**](#RentingBenefits) * [**Renting Costs**](#RentingCosts) * [**Food for Thought – Loss of flexibility**](#FoodforThought) * [**Quick Terms**](#QuickTerms) * [**Quick Answer (15:1) Ratio**](#QuickAnswer) * [**Buying Benefits**](#BuyingBenefits) * [**Buying Costs**](#BuyingCosts) * [**Renting Benefits**](#RentingBenefits) * [**Renting Costs**](#RentingCosts) * [**Food for Thought – Loss of flexibility**](#FoodforThought)   Contact Us  939 N Plum Grove Rd  Suite A  Schaumburg, IL 60173  Ph.847.619.0413  Fx.847.619.0966  [http://www.vimlantax.com](http://www.adatum.com)  [info@vimlantax.com](mailto:someone@example.com) | **“To Rent or To Buy?” That is the question!**  ***Or maybe you’ve already bought your property and would like to know which would have been the better choice. So now that the proverbial bubble has been popped, let’s have a look inside and see it for what it really was.***  **Quick Terms:** You will need to grasp a few quick terms to understand this article.   1. **Equity:** The difference between the loan balance of the home, minus its property value NOW (not what you paid for it), plus any possible appreciation dollar amount of the property. 2. **Value:** This is the appraised value, which in turn means the market value of the home within the last three months, from the perspective of a professional, licensed appraiser. Zillow.com does a decent job, but only if it gives you data for the homes sold in your area for the last three months. 3. **Liquidity:** The rate at which you can convert any asset into cash for its FULL market value. For e.g., you can sell gold for its full cash pretty quickly if you stop by at a pawn shop tomorrow, but you can’t just do that with a car, or real estate (even if it’s on craigslist) and expect to get full value. Typically there’s no number which references liquidity, but most would accept that cash is 100% liquid, while your gold is *less* liquid, followed by your home far down the ladder. 4. **Mortgage Insurance:** This “MIP” or “PMI” as it is called, is usually charged when you put down less than 20% down payment on the purchase price of a home and is the insurance premium that is usually lumped into your mortgage payment and insures your bank or lender against the risk of you defaulting on your mortgage. You are essentially paying the bank’s insurance company every month in case you do not end up making the rest of the payments on your loan. In case you do default, the insurance company then pays up the loan in some pre-agreed amount; but the bank or lender can still come after your home and other personal assets, barring you filing any sort of bankruptcy, or skipping the country. 5. **Deduction, or “Deductible”**: This is a tax term. This means your income on your tax return gets subtracted by the deduction, before tax is applied. For e.g., if your income is $70,000, you can deduct your annual mortgage interest, in this example, $10,000. The IRS taxes you on the difference of $60,000 at your tax bracket rate, not on the $70,000 you earned. There are several tax deductions. We are most concerned here, with three deductions: mortgage interest, property taxes, and mortgage insurance, which are itemized deductions. Some deductions are available to all taxpayers (called “before the line”, or “before AGI”), but in addition to those, other deductions such as PMI, mortgage interest, and property taxes are only available as a choice between either a “standard” deduction or a sum of itemized deductions. More about this later.   **Quick Answer:** [*<<back to top>>*](#_top)  About a month ago, NPR (National Public Radio) ran a story regarding the appropriate ratio of the cost of owning a home to renting it. That story is an extension of the August 2008 article on the same subject. **(**[**http://www.npr.org/templates/story/story.php?storyId=93835600**](http://www.npr.org/templates/story/story.php?storyId=93835600)**).** This ratio is made famous by Dean Baker, economist at The Center for Economic and Policy Research.  A ratio of **15 to 1 reflects relatively equal costs of owning a home to renting it.** This takes into account all costs, including any tax benefits of owning a home. Above that, say 19:1, the ratio reflects a somewhat expensive proposition; it means owning a home is more expensive to renting it. A lesser ratio amount, say, 10:1 means buying is more economical for a given area or property.  Let’s examine this ratio. If you were contemplating purchasing (or already own a home) which costs $180,000, then you should compare the yearly cost to rent that home (or a home similar to it) at the time of purchase. If the rental cost is $1,500 per month, for an annual rent of $18,000, then divide the annual rent into the cost of the home: $180,000/$18,000. You will come out with a number of 10 (meaning, 10 to 1). You can see this means renting is far superior economically to owning that home. Many of these ratios for specific areas are now found on many websites, including Trulia’s, here: [**http://www.trulia.com/blog/rudy\_bachraty/2010/06/new\_trulia\_real\_estate\_index\_rent\_vs\_buy**](http://www.trulia.com/blog/rudy_bachraty/2010/06/new_trulia_real_estate_index_rent_vs_buy)  However, this ratio will be misleading (and thus not inform you of the true costs) if you do not reside in the home for anywhere between 5 to 7 years. Almost anyone with a basic finance understanding will know that to buy and sell a home in one year is much more expensive (realtor costs, mortgage, income taxes on sale) than to hold that property for a longer duration. So only do this analysis if you are going to be in the home for at least 5 years.  **True (but lengthy) Answer:**  The proof is in the pudding; or in the numbers, for that matter. You need to consider **ALL** the costs and benefits for buying the home and tally them up in a logical format into a reliable rent vs. buy calculator. I personally have developed a calculator for this, but I like this one publically available on the Web, by a developer named Kevin Weales. [**http://www.nytimes.com/interactive/business/buy-rent-calculator.html**](http://www.nytimes.com/interactive/business/buy-rent-calculator.html)  But first, let’s look at some of the pluses and minuses of owning and renting a home.  [*<<back to top>>*](#_top)  ***Buying (Costs) – Eliminate, NAY, Accentuate the Negative!:***  The costs of buying a home are tremendous:   1. **Opportunity Cost:** This is the cash down payment you sink in as equity which you now do not have use of. You now cannot invest in something else, like a business. This loss of flexibility can be costly depending on your future plans. Having at least 9-10 months worth of all your monthly expenses (proposed mortgage payment included) available to you as immediate (liquid)cash savings in addition to your down payment should be a prerequisite prior to purchasing any home, and a co-requisite during ownership of your home, in case of job loss or any sort of emergency. Nevertheless, your down payment is still not available to you until you sell your home or take out a loan against it. 2. **Repairs or Remodeling Costs:** If it is an older home, or a single family house without a homeowners association which takes care of the exterior of the property, do consider this. Also, any sprucing up of your home through remodeling adds to your costs right now. 3. **Property Insurance** 4. **Association (Homeowners) Fees** 5. **Mortgage Interest.** 6. **Mortgage Insurance** if you put down less than 20%. 7. **Property Taxes .** 8. **Income Taxes** on the profit of your home if you owned it or lived in it for less than two years. (IRS and your state tax dept. will charge you for this on your annual tax return. Yep!) This tax rate is your marginal tax rate should you make any profit on your home in less than one year, or your long term capital gains rate if you lived and owned it for more than one year, but less than two years. Contact your tax practitioner to know your marginal and long term capital gains income tax rate. 9. **Realtor Costs** (3% to 5%). The cost to buy is hidden in the negotiated price of the home, so you won’t necessarily feel that pinch, but you will definitely feel it when you sell the property because the realtor’s commission is clearly written on the closing statement (HUD-1 settlement statement) at the very top of the second page. 10. **Closing Costs** ***to buy and sell*** the property (those pesky transfer taxes and title fees included). (Budget total 7%). This is IN ADDITION to the realtor costs if you are using a realtor. Lots of people do not take into account these costs at the time of selling their property. So make sure you do this. 11. **Time** – with your realtor, accountant, lawyer, to shop for, to repair, to sell, to look for financing, to research, etc. etc. (time is money, honey). No calculator that I have seen takes this into account. So do budget for this. 12. **Inflation** – Your home may appreciate at your expected rate, but many homeowners do not take this number into account. Typically it is around 3%. See point 13 in the buying benefits below. [*<<back to top>>*](#_top)   ***Buying (Benefits – Accentuating The Positive):***  “How about the benefits?” you ask, “I will build equity, won’t I?”. Well, let’s take a look.   1. **Appreciation** on the home is (usually 3%-5%) per year. (If you owned a home in the Chicago area for the last 23 years, your average annual appreciation rate is only 1.88%) See the Case-Schiller index here: [**http://www.standardandpoors.com/indices/sp-case-shiller-home-price-indices/en/us/?indexId=spusa-cashpidff--p-us----**](http://www.standardandpoors.com/indices/sp-case-shiller-home-price-indices/en/us/?indexId=spusa-cashpidff--p-us----) Considering that inflation is also at around 3%, your appreciation could actually be thought of as depreciation (the annual value of your home actually reducing due to the general level of prices of all other goods increasing on an annual basis)—*a heart wrenching thought.* For e.g., (1.88% - 3% = -1.12 depreciation rate). Those who come from countries where the value of the currency is highly volatile or where government institutes price level controls, can *appreciate* this concept, no pun intended. 2. **Tax Benefit:** The homebuyer credit **is no longer available** for new home purchases, and the maximum energy credit that is available to reduce your income tax liability is only $1,500. Furthermore, the tax benefit for property taxes, interest, and mortgage interest is only available to those who itemize their deductions. Considering that most taxpayers in the USA do NOT itemize their deductions **(**[**http://www.urban.org/UploadedPDF/1001054\_Share\_of\_Taxpayers.pdf**](http://www.urban.org/UploadedPDF/1001054_Share_of_Taxpayers.pdf)**)** and that many of these deductions start to phase out (get reduced) for those who are in the $150,000 (or greater) salary category (due to a nasty extra income tax known as Alternative Minimum Tax), the tax benefits can get limited very quickly. For e.g., PMI (or MIP) is entirely denied to you as a tax (itemized) deduction if your joint income is $109,000 ($54,500 if single). This is a lengthy topic and cannot be fully addressed in this article, but if you must know, the net benefit, or “effect”, of the your itemized deductions is simply your marginal tax bracket multiplied by those itemized deductions –the product number is your reduction in your income tax liability for the year. *Any GOOD rent vs. buy calculator will take this into account if you plug in your marginal tax bracket, removing this analytical guesswork for you.* Consult your tax practitioner to know your marginal tax bracket, or simply divide your federal income taxes amount by your taxable income number from your tax return.   ***Renting (Benefits)*** [*<<back to top>>*](#_top)  The benefits of renting, in my humble opinion, are   1. Flexibility and 2. Liquidity   These are two concepts which are inexorably linked. If you rent, you have the use of your liquid cash you would have sunk in as equity were you to purchase a home. You now can use this to invest in something else, such as the stock/bond market, a business, or your Aunt Sally’s horse farm. If you were stretching to buy a home in the first place, reconsider this highly underrated benefit, especially in light of the fact that you may not have the personally recommended 9-10 months of monthly expense reserves, over and above your down payment money. Yet, flexibility also means the ability to move and find other housing when you need to (for work purposes, for e.g.) and only having to give up your rent deposit. *If you had bought your home, then moving is not such an easy proposition since you would have to think about either selling your home, or renting it out to lower your monthly cash expenses.*  ***Renting (Costs)*** [*<<back to top>>*](#_top)  The costs of renting a home are not as numerous , but not to be missed:   1. **Rental Security Deposit** (usually one or two months’ worth). You may get this back if your apartment is in good shape or has no damage, so the worst case scenario is you never get this money back. Barring that, the only downside is that during the time your landlord has this money in his/her escrow possession, the opportunity cost of this money could possibly be a TV home entertainment system you could have bought with this money had you not rented. 2. **Rent** (if your rent includes cost of water or other utilities, remove this to know your actual net rent because these other utility costs are something you will always pay, whether you own or rent a home). 3. **Opportunity Cost: Appreciation** You don’t have any equity in your rental property, so you don’t really own it, hence no appreciation on your equity. 4. **Time** (time to find your property, to negotiate the rental contract and deposit, etc.). This can be a negligible cost if you do not spend much time in finding and locking down your home for rent.   ***Conclusion (Latching on to the Affirmative)*** [*<<back to top>>*](#_top)  The answer to the question of whether it is better to rent or buy a home to live in is **NOT** complex, and not in need of the of your loan officer, realtor, or any other professional, however. The answer is a two step process, and requires some homework on your part. So clear at least the next two half Sundays. First, inspect the Rent-vs-Buy ratio for the area in which you are shopping for a home. Compare the housing prices in your area and the cost to rent those types of homes. If the ratio is 15:1 or below, then you should move to the second step of plugging all your numbers for a particular property you are interested in, into a typical rent vs. buy calculator (mentioned above). Usually, people come out ahead with buying if they are living in the home for at least five years.  **Some Food for Thought**  Since most families tend to make their home their largest investment with a large amount of their cash savings used as a down payment, it is wise for such families to contemplate the loss of liquidity and thus flexibility prior to such a purchase. In addition, there are a few other things the calculator or the ratio will not do, as mentioned earlier. These things should be taken into account when the rent vs. buy calculator and/or the own-to-rent ratio are a tossup. :   1. Flexibilty/Liquidity: As mentioned, it may not be easy to get a home equity loan or sell your home, given the current economic climate, if you needed access to your equity right away. Lesson: Stay liquid and if buying, have 9-10 months of monthly expense reserves saved up. 2. Emotion: Most people have an emotional attachment to the home. No matter the cost of owning versus renting it, the true full value of the home encompasses the homeowner’s sense of prestige, pride, and/or a family’s memories for a home. Or maybe your home’s value to you is its proximity to your parents’-in-law home, to your workplace, etc. 3. Inflation (mentioned above). 4. Time: No calculator can really truly measure the cost of time. Only you know how much time is costing you.   So do not fail to plan, else you are only planning to fail. And use a rent vs. buy calculator.  ***Contact Milan Madhani, CPA at*** [***mmadhani@vimlantax.com***](mailto:mmadhani@vimlantax.com) ***or Vimal Madhani, MST at*** [***vmadhani@vimlantax.com***](mailto:vmadhani@vimlantax.com) ***with any questions/comments.***  [*<<back to top>>*](#_top) |
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