Should You Become a Homeowner?

Part 1: Should You Rent or Buy?

Related Topics

- Part 2: Unique Income Tax Benefit on a Home Sale

Quick summary:

- Deciding whether to rent or buy is both a financial decision and an emotional decision.
- On the financial side, there are three potential benefits.
- First, as a homeowner you may save money each year on income taxes with a deduction for mortgage interest and property taxes. Please consult a tax professional.
- Second, your wealth and home equity can grow through increases in your home's value and the mortgage principal payments you make.
- Finally, a home sale offers a unique income tax benefit where up to $500,000 in profits may be received as a tax-free gain.
- But no matter how good you feel about being a homeowner, bottom line, a home is still an investment. You can make money…or lose money when you sell your home.

Calculating whether buying a home now is the right move for you

Buying a home is both a financial and an emotional decision. Work through the pros and cons to see whether this is the right time for you to buy a home.

On the financial side, the following factors influence whether it makes sense to rent or buy:

- Your timeline between buying and eventually selling your home
- How much you estimate rent and home prices might change over time
- Comparing your non-tax deductible costs as a renter vs. your after-tax cost as a homeowner
- What kind of after-tax return you could get as a renter by investing your "downpayment money" plus other homeowner costs as compared to the potential -tax benefits on the sale of a home

Calculator: Use the Rent vs. Buy Calculator to see if buying a house may actually save you money over paying rent.

How long must you live there to make it pay?

The old rule of thumb was that if you owned your home for five years or more before selling it, then buying a home was a good idea.

The reasoning behind this general rule was that there are significant costs in buying and then selling a home and it takes time for your home to appreciate (go up in value) to break even on those costs, let alone make a profit on top of your purchase price.

Does the five-year rule of thumb always work? No. Sometimes it's longer and sometimes it's shorter for two main reasons:

- First, you don't know what the interest rate, real estate market, neighborhood, school or local, national and international economic conditions will be like when you're ready (or forced) to sell your home.

  The real estate market at that time may be appreciating, stagnant or depreciating. And long before you've owned your home for five years you might hit an up cycle in home prices and be able to sell at a nice profit. Unfortunately, no one has a crystal ball.

- Second, a change in your work status, health or family circumstances may find you forced to move long before you planned. A home sale doesn't happen overnight. It can take months or longer to sell a home.

  Will you be able to afford waiting long enough to get your price? Until a sale is completed, you may face making payments on two places—your existing home and another place you're renting (or buying) in another city or state.

Four reasons to become a homeowner

1. As a homeowner, you may save a considerable amount of money each year on income tax with a deduction for mortgage interest and property taxes. Ask your tax advisor about the tax benefits available and limitations.

2. Your wealth and home equity can grow through increases in your home's value and the mortgage principal payments you make.

3. A home sale offers a unique income tax benefit with potentially up to $500,000 in gain(s) excluded from federal and possibly state income tax. See Unique Income Tax Benefit on a Home Sale.

4. There's a special feeling being a homeowner.

But it's important to remember that a home is more than a roof over your head and something that may make you feel good. It's also an investment—one that can make you money…or lose your money. That's why you always need to treat a home as an investment and not let your emotions take control.

Pros and cons of buying vs. renting

To give you perspective on the pros and cons of buying vs. renting, look at this chart:

Comparison of Buying vs. Renting

Buying	**Renting**
1. When you want (or need) to move, home values may be down and it may take a long time to find a buyer and complete a sale.	1. Once your lease term is up, you can just move. You're not tied down. However, once your lease is up, your landlord may be able to make you move even if you want to stay.
2. Your home is an investment. There's the potential for profit *or* loss on the eventual sale of your home. The size of your investment is your downpayment money, monthly mortgage payments, property taxes, insurance, maintenance, repairs and other out-of-pocket costs. On some of these, you may be able to benefit from income tax deductions to lower your true cost.	2. You may not think you're investing; you're renting. However, as a renter you could invest a "downpayment" and other home-related money in other types of investments such as stocks or mutual funds.
3. A sale of a home may offer a unique income tax benefit. Up to $500,000 in gain may be excluded from federal and state income tax. See Unique Income Tax Benefit on a Home Sale.	3. Gains on other investments may be subject to income tax.
4. Subject to limitations, you may get income tax deductions for your mortgage interest and property taxes. These tax deductions may reduce the bottom line cost of your home.	4. You don't deduct your rent payments for income tax purposes. However, there may be a limited state tax credit or benefit available to you as a renter.
5. You may have more control over housing costs, especially with a fixed-rate mortgage (loan). Once your loan is paid off, you can live "rent free" in your home and just pay the property taxes, insurance, repairs, maintenance and utility costs.	5. As a renter, you never stop paying rent. Your rent cost will probably go up over time although rent control or market conditions may limit the amount of future increases.
6. It can just feel good to be a homeowner.	6. It can just feel good to be a renter. As a renter, you aren't tied down to a mortgage. This financial freedom may allow you more flexibility in choosing a job, a career, where you live or your retirement date.
7. If you have financial problems down the road, your home may have more protection against creditors than other assets in some cases.	7. You may use your "house money" to instead invest in retirement plans, IRAs, annuities and life insurance which can be very or somewhat protective against creditors depending upon the applicable laws.

The emotional component

The feeling of walking around your own home knowing you own it can be special. There's a value for this that isn't quite quantifiable in dollars.

Making the final decision

It's not easy to make the decision to buy a home. It can be scary.

Maybe you should sleep on it—literally. Take out a piece of paper and write on it "Monthly housing expenses $____ for the next 30 years," fill in a dollar amount and put that paper under your pillow.

Each morning, for a week, pick up that piece of paper and read it so it seems more real, more tangible to you. Then see how you function during the day and how well (or poorly) you sleep at night. This may give you some insight into your (dis)comfort level of becoming a homeowner before you actually commit your dollars and yourself.

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Should You Become a Homeowner?

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Quick summary:

- Any investment, including a home, can have an income tax impact when you sell it.
- On a home sale, you may qualify for a unique tax benefit. When you sell your home, you may be able to exclude up to $500,000 of the gain from federal income tax and possibly state income tax, too.
- Federal and state income tax laws may be different. Tax laws may change over time.

Income tax laws encourage home ownership from start to finish

While you own your home, you may be entitled to an income tax deduction for the mortgage interest and property taxes you pay. And when you sell your home, you may be able to exclude some or all of the gain from income tax.

Reducing or eliminating taxes on the sale of your primary residence

The federal income tax rules allow you to exclude up to $250,000 or $500,000 in gain from income tax. To qualify for the exclusion, ownership and use tests must be met. Your state's income tax laws may be different.

Single persons

Single persons who meet the tax requirements may qualify to exclude up to $250,000 in gain on the sale of a principal residence.

Married couples

Married couples filing a joint income tax return may be able to exclude up to $500,000 of gain.

Tax benefit available repeatedly throughout your lifetime

Hard as it may be to believe, this $250,000/$500,000 exclusion is *not* a one-time thing. If you qualify, you can use it repeatedly throughout your lifetime. As with any tax benefit, there's some fine print.

The two-year rule

The general rule is that you can qualify to exclude the gain if you both own and use the home as a principal residence for periods totaling two years or more during the five years before the sale. There are special rules where there is a divorce, marrying someone who has used the exclusion within the last two years and for military and foreign service personnel.

Exceptions for shorter periods

What if you can't meet the two-year rule? Can you get any tax benefit for a shorter period of time? It depends. The tax law provides certain exceptions to the two-year rule. There are many technicalities to this rule so consult with your tax advisor for the exact details.

Get up-to-date tax advice

Check with your tax advisor before you decide to sell to see whether and when you'll meet the requirements to get a full or partial exclusion. Also ask whether the exclusion will apply on your state and local income tax returns, too.

Income tax is a very technical area, and the rules can change at any time. You need good, up-to-date advice to successfully navigate your way through the tax code. It may be your CPA or your attorney who's qualified to advise you.